A FURTHER EXAMINATION OF FEDERAL RESERVE REFORM PROPOSALS

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BEFORE THE

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OF THE

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WITNESSES

WEDNESDAY, JANUARY 10, 2018

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

A FURTHER EXAMINATION OF FEDERAL RESERVE REFORM PROPOSALS

Wednesday, January 10, 2018

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

The subcommittee met, pursuant to notice, at 2:03 p.m., in room 2128, Rayburn House Office Building, Hon. Andy Barr [chairman of the subcommittee] presiding.

Present: Representatives Barr, Williams, Lucas, Huizenga, Pittenger, Hill, Emmer, Mooney, Davidson, Tenney, Hollingsworth, Hensarling, Moore, Foster, Sherman, Green, Kildee, and Vargas.

Chairman BARR. The committee will come to order.

Without objection, the Chair is authorized to declare a recess of the committee at any time, and all Members will have 5 legislative days within which to submit extraneous materials to the Chair for inclusion in the record.

We have had some unscheduled votes come up throughout the day. We may have that again. So I apologize in advance if this is a bit of a start-and-stop hearing because of that. We will try to avoid that if we can.

This hearing is entitled "A Further Examination of Federal Reserve Reform Proposals."

I now recognize myself for 5 minutes to give an opening statement.

Today we are turning the corner on monetary policy. We will soon have a Federal Reserve Board Chairman and additional confirmations to the Board of Governors. We are excited about what personnel change can bring in terms of a more reliable monetary policy for American economic opportunities, and we remain interested in bipartisan reforms that can improve the deliberative processes and policy transparency.

During today's hearing, we will consider important legislative proposals to improve the rules of the game for both our monetary policymakers and Congressional overseers. These reforms provide for a monetary policy that is better informed about economic conditions throughout the country while focusing our Federal Reserve on what it can do and only what it can do.

Monetary policy can appear complicated, but unless we fortify its ability to signal when and where goods and services can further productive opportunities, we cannot fulfill our economic potential.

Two years ago, the House of Representatives passed our Fed Oversight Reform and Modernization Act. As we meet today, we have a chance to move this and related legislation even further.

Some detractors persist with the mantra that except for the Fed's great monetary distortion our economy would have fallen into another Great Depression. According to them, we should be thanking the Fed, not reforming it. It is true that our economy is performing better than many, but "better than many" is the wrong metric for America and Americans. The right measure is whether we are performing as strongly as we can. The fact that our recent recovery was considerably weaker than previous post-war rebounds says that we can and must do better to live up to our potential.

The good news is that we are off to a strong start. The past 2 quarters of 3-percent growth are promising, and the New York Fed's latest "Nowcasting Report" predicts an even stronger 4-percent growth rate for the last quarter of 2017.

Our efforts going forward will be more effective if we understand how we got here. And we got here in considerable part by asking more from our monetary policy than it could possibly deliver.

Some of us remember the Rock and Roll Hall of Fame band Jefferson Starship. One of their hit songs includes the phrase, "If only you believe in miracles, we'd get by." A catchy tune for sure, but monetary policies should not depend on miracles.

Year after year, the American people were told that the promise of unconventional policies would appear soon. Almost a decade out of the financial crisis, we must stop waiting and start doing. Legislation under consideration today builds on the foundation of local knowledge and individual incentives—fundamentals that are absent from too many of our policy discussions.

Some economists insist that our best days are behind us. They tell us that the most unconventional policy responses to the Great Recession had nothing to do with an economy that had to wait for the last election to start showing signs of life. By ignoring that macro performance depends on micro decisions. Top-down models assume a supernatural capacity to optimally control the most complex of systems, our economy.

But just as businesses cannot continually hide mismanagement behind financial engineering, governments cannot support true prosperity by opportunistically diverting scarce resources into politically favored national income accounts.

Almost a decade out from the Great Recession, returning to a more reliable monetary policy is long overdue. It is time to abandon the improvisation at the Federal Reserve. Monetary policy distortions helped us get into the recession. More of the same will not bring a stronger recovery.

Monetary policy needs to return to doing what it can and only what it can, and that is consistently producing an efficient exchange medium so that real goods and services, which include labor, can freely engage in their most promising opportunities. Legislation that we will consider today does just that.

And, with that, I now recognize the gentleman from California, Mr. Sherman, for 2 minutes for an opening statement.

Mr. SHERMAN. Thank you. Mr. Chairman, you have made me feel very old. I have always known them as Jefferson Airplane.

Chairman BARR. Yes.

Mr. SHERMAN. The legitimacy of our Federal Government and all of our governments is based on the theory of democracy. But the enemies of democracy take refuge in the belief that, while we elect some people, we don't actually let them make the important decisions and that the elitists will control the entities that make the important decisions.

The most important decisions discussed in this room are those made by the Fed, where the elected representatives of the people get to kibitz but the people actually making decisions are well removed from the concept of democracy. But many of them are, in fact, appointees of the President, but others are selected by the theory of one bank, one vote. Now, we now have A, B, and C levels, but that B level is selected by the banks, meaning that critically important Governmental decisions are made where the banks have votes and the people don't.

This is exacerbated by the fact that not only do we have this one bank, one vote, but California gets as much clout as areas that have less than half of its population. So democracy is thwarted in two ways. We ought to move forward to the idea that Government decisions in America should be made by those selected by elected leaders.

In addition, the Fed made as much as $100 billion in a year profit by mistake. If we have the people of America told that they are allowed to look at what the Fed does, and not just on the Bloomberg channel, we would be insisting that any policy that produces $100 billion for the Federal Government be looked at as a policy that might generate $100 billion profit for the Federal Government and that that cannot be ignored just because the elitists say they did it by mistake, therefore it doesn't count.

I look forward to a true democracy in this country. I am old, but I hope I am young enough to see it.

I yield back.

Chairman BARR. The gentlemen's time has expired.

The Chair now recognizes the distinguished Ranking Member for an opening statement for 3 minutes.

Ms. MOORE. And thank you so much, Mr. Chairman and committee. And thank you to our witnesses gathered here.

Today, we are going to be examining several pieces of legislation that are identical or substantively the same as we have considered before, and legislation that I am opposed to. Collectively, this legislation represents the proverbial solution in search of a problem. Of course, these solutions aren't the problem, in many of cases.

Let us take legislation that would allow bankers even more power to appoint the president of the Federal Reserve banks. Now, this would unwind an important Dodd-Frank reform to diversify the concerns and opinions the Fed considers. This reform is a slap in the face to Americans. And it is so counterintuitive to the majority, to the Republican talking points about being tough on Wall Street, and then turning around and betraying our constituents by selling them out to Wall Street banks.

Deutsche Bank just got done being mired in lots of scandals, including rigging LIBOR and helping Russians launder money and get around U.S. sanctions. Deutsche Bank also makes questionable

loans to our President, and this committee refuses to even look into those loans for Deutsche Bank. In other news, our President waives part of the punishment imposed on the Deutsche Bank, even as he owes it hundreds of millions of dollars in loans that have raised a lot of eyebrows.

These bills make little sense in the best of times, like appropriating money for the Fed. The GOP has weaponized funding regulators at the request of the regulated entities. Ask the SEC (U.S. Securities and Exchange Commission), ask the CFTC, and, of course, you could also ask the EPA.

Given the ongoing scandal of global money laundering and illicit financing and pay-for-play in this Administration, I simply don't want to open the door for another avenue for these obstructions of sound financial regulation by appropriating the Fed.

I have letters to enter into the record, Mr. Chairman, without objection. I have Americans for Financial Reform, a statement; and a statement from Dr. Josh Bivens, Research Director of the Economic Policy Institute; and a statement from Dr. Jared Bernstein, economist at the Center on Budget and Policy Priorities.

Chairman BARR. Without objection.

Ms. MOORE. Thank you. And I yield back.

Chairman BARR. The gentlelady yields back.

Today, we welcome the testimony of four distinguished witnesses.

First, Dr. Norbert Michel, who is the Director of the Center for Data Analysis at The Heritage Foundation, where he studies and writes about financial markets and monetary policy. Before rejoining Heritage in 2013, Michel was a tenured professor at Nicholls State University's College of Business, teaching finance, economics, and statistics. Dr. Michel holds a doctoral degree in financial economics from the University of New Orleans. He received his bachelor of business administration in finance and economics from Loyola University.

Mr. Alex Pollock is a distinguished Senior Fellow with the R Street Institute, providing thought and policy leadership on financial systems, cycles of booms and busts, financial crises, risk and uncertainty, central banking, and the politics of finance. Alex joined R Street in January 2016 from the American Enterprise Institute, where he was a resident fellow from 2004 to 2015. He previously was President and CEO of the Federal Home Loan Bank of Chicago from 1991 to 2004. He received his bachelor's from Williams College, has a master's in philosophy from the University of Chicago, and a master of public administration degree in international affairs from Princeton University.

Dr. Dean Baker is the Co-founder and Co-director and Senior Economist at the Center for Economic and Policy Research. His areas of research include housing and macroeconomics, intellectual property, Social Security, Medicare, and European labor markets. Dean previously worked as a senior economist at the Economic Policy Institute and as an assistant professor at Bucknell University. He has also worked as a consultant for the World Bank, the Joint Economic Committee of the U.S. Congress, and the OECD's Trade Union Advisory Council. He received his B.A. from Swarthmore

College and his Ph.D. in economics from the University of Michigan.

Last but not least, Dr. George Selgin is a Senior Fellow and Director of the Center for Monetary and Financial Alternatives at the Cato Institute and Professor Emeritus of economics at the University of Georgia. His research covers a broad range of topics within the field of monetary economics. Selgin retired from the University of Georgia to join Cato in September 2014. He has also taught at George Mason University, the University of Hong Kong, and West Virginia University. He holds a B.A. in economics and zoology from Drew University and a Ph.D. in economics from New York University.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. Without objection, each of your written statements will be made part of the record.

And, Dr. Norbert Michel, you are now recognized for 5 minutes.

STATEMENT OF NORBERT J. MICHEL

Dr. MICHEL. Thank you.

Chairman Barr, Ranking Member Moore, Members of the committee, thank you for the opportunity to testify today.

Though I am the Director for the Center for Data Analysis at The Heritage Foundation, the views that I express in this testimony are mine. They should be not construed as representing any official position of The Heritage Foundation.

Congress could enact many reforms that would improve the transparency of the Federal Reserve's operations as well as the Fed's accountability. What should be obvious but what is often ignored is that the Federal Reserve is, in fact, a creature of Congress. Any operational independence that the Fed enjoys should definitely apply to the Fed's independence from the Executive Branch. The Federal Reserve, however, should always remain accountable to the public through its elected representatives in Congress.

One set of possible reforms deals with changing the Fed's ability to pay interest on reserves, a power that Congress granted to the Fed ahead of its original schedule during the 2008 crisis.

The record shows that Congress did not make this policy change to alter the Fed's main tool for monetary control, but that is exactly what the Fed ended up doing once it had this authority, ultimately using it to supplant, rather than supplement, its traditional open market operations. Though certainly not Congress' intent, allowing the Fed to pay interest on excess reserves has enhanced the Fed's ability to allocate credit to specific entities rather than to provide systemwide liquidity.

Congress now has several options to hold the Fed more accountable and fix this problem: One, allow the Federal Open Market Committee, rather than the Board of Governors, to set the rate paid on reserve balances; two, clarify the statutory meaning of "general level of short-term interest rates" so that the Fed cannot pay above-market rates; and, three, remove the Fed's authority to pay interest on excess reserves entirely, which would be my preferred of the three.

Another set of reforms deals with restoring the original decentralized model that Congress used to create the Federal Reserve System. The present-day Fed looks and acts quite differently than the system that Congress originally created, and one of the glaring differences is the increased centralization of the Fed's power inside Washington, D.C.

In 1935, Congress replaced the original Federal Reserve Board with the seven-member Board of Governors that exists today, and it also created the Federal Open Market Committee. From its creation, all seven members of the board, the New York Fed president, and four rotating district bank presidents have had voting seats on the FOMC (Federal Open Market Committee), thus ensuring that the Fed's power would remain centralized in Washington, D.C.

Congress can implement several policies in this area to rectify that mistake, thus restoring the more decentralized approach. For instance, Congress could change the makeup of the committee so that one representative from each district bank has a voting seat or, instead, increase the number of voting seats that district banks have on the committee to either six or seven to lessen the advantage. Either way, Congress should ensure that the New York Fed is no longer the only district bank with a permanent voting seat on the committee.

Finally, because Congress has delegated so much authority to the Fed, there are several other smaller policy changes that Congress should make to ensure more transparency and better accountability.

One straightforward improvement would be to subject the Fed's nonmonetary policy functions to the regular congressional appropriations process, thus giving Congress a powerful tool to hold the Fed accountable.

Another direct fix, to amend the Federal Reserve Act to define the blackout period surrounding the committee meeting and to specify exactly which types of communications apply. The existing type of vague and unclear requirements always hinder transparency.

Two additional improvements that I would identify would be requiring Congressional testimony from an alternate Fed official when the Vice Chair of Supervision is vacant and, second, holding all Federal Reserve staff to the same disclosure and ethics standards as those of the SEC.

Ultimately, Congress could improve accountability and transparency of the central bank by narrowing the Fed's scope of responsibilities so that it is no longer a regulator at all, thus focusing the central bank on monetary policy, which is what it was supposed to do originally. This change would fit naturally with giving all Fed district banks a voting seat on the FOMC, ending in better representation for all areas of the country.

Thank you, and I look forward to any questions you may have.

[The prepared statement of Dr. Michel can be found on page 43 of the Appendix]

Chairman BARR. Thank you.

Mr. Pollock, you are recognized for 5 minutes.

STATEMENT OF ALEX J. POLLOCK

Mr. POLLOCK. Thank you, Mr. Chairman, Ranking Member Moore, and Members of the subcommittee.

The proposals under consideration today are all parts of a timely and fundamental review of America's central bank. From James Madison, who wanted to protect the new United States from a "rage for paper money," as he said, to now, money has always been and is an inherently political issue, involving questions not amenable to technocratic solutions but requiring judgments about the general welfare.

For example, Congress instructed the Federal Reserve in statute to pursue, quote, "stable prices," unquote. But the Federal Reserve decided on its own that the term "stable prices" means perpetual inflation at the rate of 2 percent a year. This reasonably could be viewed as a contradiction in terms but certainly raises the question, who should have the power to make such judgments, the Fed by itself or the Congress, having heard from the Fed and others?

Under the Fed's current fiat money regime, we have experienced the great inflation of the 1970's, the financial crises of the 1980's, the bubbles and crises of the 1990's and 2000's, and the radical asset price inflation of the 2010's, the outcome of which is as yet unknown. Since the economic and financial future is unknowable, the Fed is incapable of knowing what the results of its own actions will be.

How should the Fed be accountable for its various judgments, guesses, and gambles, and to whom? And, at the same time, how should it be accountable for how it spends the taxpayers' money and how it makes decisions?

I believe there are four general categories for this discussion: One, the accountability of the Federal Reserve; two, the checks and balances appropriate to the Fed; three, the centralized versus Federal elements in the Fed's own structure; and, four, dealing with uncertainty.

On accountability, the power to define and manage money is granted by the Constitution to Congress. There can be no doubt that the Federal Reserve is a creature of and accountable to the Congress, just as Norbert said. And the Congress, of course, represents the people, for whom the nature and potential abuse of their money is always a fundamental issue.

The primary central bank independence problem, in my view, is independence from the executive. The executive naturally wants its programs and especially its wars financed by the central bank as needed, and a lot of history demonstrates this. And some of it is in my written testimony.

I think it is important to realize that the Federal Reserve Reform Act of 1977 and the Humphrey-Hawkins Act of 1978 were attempts under Democratic Party leadership to make the Fed more accountable to Congress, just as we are talking about today. This was the right idea, but I think it is fair to say these attempts were not successful.

The most fundamental power of the legislature is the power of the purse, and Congress can use this essential power for Fed accountability. Every dollar of Fed expense is taxpayer money and would go to the Treasury's general fund if not spent by the Fed on

itself. Since it is taxpayer money, the proposal to subject the Fed to appropriations, in my view, makes sense.

Checks and balances are essential to our constitutional Government and to every part of it, including the Federal Reserve. Since the Fed has amassed huge regulatory power, the Congress should require additional reporting regarding the Fed's regulatory plans and rules, especially in its new role as the dominant regulator of systemic risk.

The original Federal Reserve Act of 1913 tried to balance regional and central power, hence the name Federal Reserve System, not Bank of the United States. This theory lost out in 1935, but, in my view, adjustment back to a more dispersed power within the Fed would make sense.

And three of the draft bills under consideration move in this direction and are, in my opinion, all appropriate reforms, as are anything which increases the intellectual diversification of Federal Reserve operations. And a number of the bills do that.

In sum, the Federal Reserve needs to be accountable to the Congress, to be subject to appropriate checks and balances, be understood in the context of inherent financial and economic uncertainty, and would benefit from rebalancing of centralized versus Federal elements in its internal structures.

Thank you for the opportunity to share these views.

[The prepared statement of Mr. Pollock can be found on page 51 of the Appendix]

Chairman BARR. Thank you, Mr. Pollock.

Dr. Baker, you are recognized for 5 minutes.

STATEMENT OF DEAN BAKER

Dr. BAKER. Thank you, Chairman Barr and Ranking Member Moore. I appreciate the opportunity to address you and the Members of the subcommittee.

I will address the seven proposals that you asked us to speak about, but first I would like to give at least my assessment of how we should think about the Federal Reserve. And basically what I would say is that we have, to some extent, an anachronism.

The Federal Reserve Act, of course, created over a century ago, and, at that time, it was created as a mixed public-private entity. And, in that way, the Federal Reserve Bank is really an outlier among other central banks, pretty much all of which—I am saying "pretty much all" because there is maybe one I don't know of—but pretty much all of which are fully public entities. So if you look at the European Central Bank, the Bank of England, the Bank of Canada, these are all fully public entities.

So the idea that we have a mixed public-private entity is really an anachronism that I think is historically the wrong direction and certainly puts us out of line with the rest of the world.

And it creates this perverse situation that Representative Sherman referred to in his opening comments where we have banks that have a say on monetary policy and, perhaps even more perversely, have a role in naming their own regulators. While we would, of course, welcome the input of the financial sector, the banking industry in monetary policy, as we would other sectors,

the idea that they have particular insight that we need in the structure of monetary policy I find hard to understand.

Furthermore, in terms of having them select their own regulators, we all recognize that the affected industry—the pharmaceutical industry is going to lobby the Food and Drug Administration to promote its interests, or the telecommunications industry will lobby the Federal Communications Commission. We don't let them pick commissioners. And that is, in effect, what we have in the current structure of the Fed.

So, from that vantage point, my view is we should be moving toward a more strictly public Fed. And I put these categories and proposals into two categories: One, shifting power back toward the banks, away from the appointed Governors; and, two, questions of governance, more narrow questions of governance that—well, I will come to those—I think, in some ways, can be seen as perhaps harassing the Federal Reserve Board.

On the first question of putting more power in the hands of the banks, well, allowing Class A directors to vote for bank presidents is very directly giving more power to the banks over selecting the regional bank presidents. That was a very conscious decision in the Dodd-Frank bill, to move in the opposite direction, to try and take away power from the banks in that selection, although, as Representative Sherman pointed out, they still select the Class B directors, which means they have half the votes when you have a bank president being considered.

The second issue, have all the bank presidents vote on the FOMC, again, this is a question of giving more power to unelected officials, giving power—or I shouldn't say "unelected officials"—people who are not appointed through the democratic process. It is giving power to people who are selected by the banks. I cannot see why you would want to go in that direction.

The third in that vein is to have the FOMC determine the interest rates on reserves. This is a little perplexing to me because, in my view, the key question here is the policy instrument, what policy being decided, which, of course, is in general the interest rate on overnight money, the Federal funds rate, and the interest rate on reserves is a way to target that. So I am a little bit at a loss, what the committee or Congress should be looking to do by having the whole FOMC vote on interest rates on reserves. It just seems to me a rather peculiar policy.

I should also point out, there seems to be some idea here that the Fed has failed. And, obviously, one could argue whether it has failed or succeeded. But if we look at which direction it has gone, it has failed to hit its inflation target. We have consistently been below the 2-percent target. And I realize some people may not like 2 percent as an inflation target, but the Fed, of course, has been very public about that. And Congress could tell them they should have another target if Congress felt otherwise. So they have been very open on that being their target. They have been under that target consistently ever since the Great Recession.

And we did an analysis looking at votes of bank presidents—dissents, I should say, of bank presidents in the last 25 years, the whole period for which reasons were given. And of 72 dissents, 64 were for more restrictive monetary policy, meaning they would

have given us still lower inflation. So, in other words, they would not have been right. If we gave them more votes, we would be more wrong than we are today.

Very quickly, dealing with the other issues, I will just mention the appropriations issue. I do think Congress does have control over the purse. On the other hand, I would hate to see it decided on a year-to-year basis. What I thought—I mention it in my testimony—there is a formula for appropriating money or allocating money to the Consumer Financial Protection Bureau. I would recommend something comparable to the Fed, that whether it be—you could target to GDP. I mean, one could pick other targets, say, one-tenth of 1 percent GDP, that might be allocated to the Fed. And that way, you could say, this is how much money you have, and Congress will have exercised its function here.

Thank you.

[The prepared statement of Dr. Baker can be found on page 36 of the Appendix]

Chairman BARR. Thank you, Dr. Baker.

Dr. Selgin, you are recognized for 5 minutes.

STATEMENT OF GEORGE SELGIN

Dr. SELGIN. Thank you, Chairman Barr, Ranking Member Moore, and distinguished committee Members. I appreciate the opportunity to testify today on the topic of reforming the Fed. My remarks will concern exclusively the proposal to make the FOMC officially responsible for setting the interest rate paid on banks' excess reserves.

From the mid-1930's until recently, legal responsibility for monetary policy has rested with the FOMC, the Federal Open Market Committee, which, as has been mentioned, is made up of the seven members of the Federal Reserve Board of Governors, plus five regional Federal Reserve bank presidents.

During the last crisis, however, that longstanding role came to an abrupt, if little noticed, end. The proximate cause of this change was the 2008 Emergency Economic Stabilization Act. That act allowed the Fed to immediately begin paying interest on banks' reserve balances, as the 2006 Financial Services Regulatory Relief Act would have allowed them to do, though not starting until 3 years later.

As the name of the 2006 act suggests, its purpose was to relieve banks from burdensome reserve requirements by modestly compensating them for holding required reserves. Interest on reserves was not supposed to be a means for regulating monetary policy. For these reasons, the interest rate on reserves was, by law, not supposed to, quote, "exceed the general level of short-term interest rates." Consistent with the 2006 act's limited aims, it allowed the Board of Governors, rather than the FOMC, to set interest rates on banks' reserve balances.

Now, the Emergency Economic Stabilization Act left these provisions unchanged. But in October 2008, when that act went into effect, the Fed had entirely different reasons for wishing to pay interest on banks' reserve balances. Primarily, it wanted not merely to compensate banks for holding required reserves but to entice them

to accumulate excess reserves that were coming their way as a result of the Fed's emergency lending.

Thus, the payment of interest on excess reserves, particularly, was transformed into a monetary policy tool. Open market operations, the FOMC's traditional means of regulating monetary policy, in turn became useless, as banks found holding reserves more lucrative than lending them.

Now, the Fed relies almost exclusively on changes in the interest rate it pays on excess reserve balances to adjust its policy stance, where that interest rate is determined not by the FOMC but by the Federal Reserve Board.

So, while the FOMC is supposed to be in charge of monetary policy by law, the Federal Reserve Board is really in charge. The regional bank presidents have, in consequence, been deprived of one of the more important roles assigned to them when the Fed was founded and continued by subsequent revisions of the Federal Reserve Act.

I believe that Congress has a clear duty to put responsibility for the monetary policy decisionmaking back where it is supposed to have been all along. It can do this in either of two ways: First, Congress might revise the 2006 statute so that it allows the FOMC, rather than the Federal Reserve Board, to set interest rates on bank reserve balances, which is the proposal that has been made.

Alternatively, though, Congress might prevent the Fed from continuing to use interest on reserves as a monetary policy tool. It can do that also in two ways: It could restrict interest payments to required reserve balances. Alternatively, it could strictly enforce the provision in the 2006 act saying that interest rates should not "exceed the general level of short-term interest rates" by specifically defining that phrase to mean that the rate of interest on reserves should not exceed the Federal Reserve Bank of New York's benchmark Broad Treasury Financing Rate, which is a perfectly useful indicator of general short-term rates.

For reasons I spelled out in detail in my July 2017 testimony to this committee, I favored the latter set of alternatives.

Thank you very much.

[The prepared statement of Dr. Selgin can be found on page 56 of the Appendix]

Chairman BARR. I thank all of you for your testimony. And we will begin, and I will recognize myself for 5 minutes of questioning.

Let me start with you, Mr. Pollock. You have heard the opening statement of my good friend, the Ranking Member. You have heard criticisms from others challenging this legislative proposal that would subject the regulatory and supervisory functions of the Fed to the Congressional appropriations process.

Could you respond or would you be willing to respond to the critique that subjecting the Fed to the appropriations process would politicize the Federal Reserve System or compromise, quote, "Fed independence"?

Mr. POLLOCK. Mr. Chairman, I would be very happy to do that.

Let me repeat to begin with that the Federal Reserve is a creature of Congress and should be a creature of Congress and accountable to the Congress, and the power of the purse is the fundamental power of Congress.

In this way, I think the proposal takes us to exactly what the constitutional design is—that is to say, the Congress is responsible for the definition of money and the management of money, in which the Federal Reserve is its helper. And the notion that the Federal Reserve or any Government body should be independent of the Congress is, in my opinion, a grave and very costly mistake.

Chairman BARR. Thank you.

And I would note that that legislative proposal does not tinker with the monetary policy functions of the Federal Reserve. It relates specifically to Congressional oversight of the regulatory functions and operations of the Federal Reserve.

Could you comment also or elaborate on your testimony that dispersed power is important for a monetary policy authority and whether the legislation under consideration today can provide for a more fully informed monetary policy?

Mr. POLLOCK. Mr. Chairman, I think the fundamental truth that has to be confronted, as I tried to suggest in my testimony, is that everything about monetary policy and the economic and financial future is subject to extreme uncertainty. It is not a matter which can be delegated successfully to experts. And it doesn't matter how many hundreds of economists the Federal Reserve hires; they don't get it any more right than anybody else does when it comes to knowing what should be done.

Therefore, in my opinion, diversification of the Fed's intellectual and informational deliberations is essential. That is the single best thing, in my view, you can do to combat the fundamental uncertainty.

And having the Federal system with all banks involved—and I think all banks voting also makes sense—as well as empowering the other Governors, the non-Chairman Governors of the Federal Reserve, to carry out their own research and projects helps increase that intellectual diversification. You might still not get it right, but at least you will have a greater variety of thought and information to help in your efforts.

Chairman BARR. Thank you very much.

And, Dr. Michel, you heard what Dr. Baker's concerns were with respect to restoring the authority of Class A directors to select district bank presidents. I think his argument is that you don't want the banks themselves to be selecting their regulators.

But my question to you is, are you aware of any actual conflicts of interests that may have motivated this section of Dodd-Frank, or was this silencing of district bank shareholders to further centralize—was the goal to further centralize the selection of district bank leaders in Washington? And what is the advantage of having a decentralized agency that is more compatible with American federalism?

Dr. MICHEL. Sir, I think it was an effort to centralize more power here. I don't recall—although I may have missed one—I don't recall ever seeing such a case with a conflict of interest that was brought to light.

And the advantages are many, in the sense that you have a large, diverse set of opinions. If anything, on the down side of decentralizing things, you might get smaller mistakes and not larger

mistakes, which would be a good thing. I think it is much more in the spirit of the federalism-type system that was put in place.

Chairman BARR. And I would just add in my remaining time that shareholders of other corporations have proxy rights, and they have a right to have a say in the corporate governance. And I think that analogue would serve the Federal Reserve well, as well.

With that, my time has expired, and I would recognize the Ranking Member for 5 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman.

You know, I always really, really enjoy being a Member of Congress, because every meeting is a master class, with a distinguished panel like this.

And I am particularly appreciative of the master class we got from you, Dr. Pollock, on the functions and priorities and privileges of Article I of the Constitution. We will call you back so that you can repeat to our colleagues and perhaps even people over there on the other side of Pennsylvania Avenue, if they decide "we are going to build a wall, no matter what," that it is within the purview of Congress to decide those things.

But for those of you who are not legislators by trade, just let me tell you what the appropriations process would be like. The appropriations process comes under an open rule. And we would have hundreds of amendments, even people sitting on this side of the dais, that side of the dais—I can see it now: No funds shall be used from this appropriation to collect data on the real estate market. And how do you then make decisions on the economy and set market with an amendment like that that may pass because somebody might want to hide what the real estate market is doing?

You are going to see amendments like "no funds in this bill"—or "funds in this bill shall be transferred from the New York Fed to the nonexistent L.A. Fed."

Sorry about that, Sherman.

But you would see that amendment coming up.

And so I am very, very concerned that, while it may be admirable—and I certainly agree that Article I needs to be more powerful—that this would wreak absolute chaos in this body. I can just see it now. I came up with all kinds of examples on this as I was listening to you, thinking about the hundreds of amendments that would come into line. And so I am offering to you a master class on what would happen if it were subject to the appropriations process.

I guess I want to ask Dr. Baker to answer some questions. Some of these proposals do seem—or maybe for anybody on the panel—some of them do seem like they could be good adjustments. But I am very curious about the notion that political influence would not occur in the Fed with these recommendations, and particularly the one on the appropriations process.

I understood, Dr. Baker, that you said maybe some sort of formula could be devised. But I am asking you, if you don't think that I am—I am concerned about the tricks that could be applied in the appropriations process. As you know, we don't pass appropriations bills on time, not since I have been here. Maybe that is going to happen someday.

And so I am curious as to why the panel chooses—there are so many worthy proposals in here—why they choose this hill to die on.

Dr. BAKER. Well, I will just briefly comment, since you originally directed it to me.

I completely agree with your concerns there, which is why I was saying some sort of formula. Obviously, Congress could change that formula, but presumably it wouldn't be done lightly. You did do that with the Consumer Financial Protection Bureau. I think you could do something comparable.

And your point, in addition to what Congress might do, I should also point out, I don't think the world breaks up easily into monetary policy and nonmonetary policy. So, when I first saw that, I was imagining a lot of things that the Fed would be doing, or at least I would be doing if I were at the Fed, which would be monetary policy, which a lot of people could say, no, that is getting into regulation. The world isn't cut that way.

Ms. MOORE. That is right.

Dr. BAKER. So, if you want to appropriate for the Fed, obviously you have the authority to do that. But the idea that you are going to separate monetary and nonmonetary policy, I don't see any way you could—

Ms. MOORE. I don't either.

And we have some very stable geniuses here in the Congress. And so I am not sure that people on the—and we have wonderful appropriators—that they are capable of deciding how much we should or should not spend on collecting data or evaluating certain market forces.

There will be an amendment saying that "no funds shall be used to enforce the dual mandate for unemployment."

And so, with that, I would gladly yield back to the Chairman.

Chairman BARR. Thank you very much.

The gentlelady yields back, and the Chair now recognizes the Vice Chairman of the subcommittee, Mr. Williams from Texas.

Mr. WILLIAMS. Thank you, Mr. Chairman and Ranking Member Moore, and thank all of you for holding today's hearing.

While I am excited about incoming Federal Reserve Board Chairman Powell, I feel that the Fed is in desperate need of reform. The time for that reform is now, and I am glad that this afternoon we will examine a series of proposals seeking to increase the effectiveness and accountability that the Fed has been lacking. For too long, the Fed has just, frankly, run wild, taking actions as it sees fit and concentrating its power inside the Beltway, and it is time to make a change.

The proposals before us offer many solutions to very important problems in the Federal Reserve System. Of note is my proposal, the FOMC Representation Improvement Act, which will allow the FOMC to make more informed monetary policy decisions by giving representation to all 12 district bank representatives.

It is like many of the proposals before us today; it is straightforward and common sense. I am optimistic that we will make headway. And I look forward to the expert testimony of all of you today, and I thank all of you for being here.

So my first question is to you, Dr. Michel. Thank you for being here and for your informative testimony on the best ways to, as you put it, lessen the centralization that has developed in the Federal Reserve system.

Now, many of the proposals before us are in that spirit. My proposal, called, as I said earlier, the FOMC Representation Improvement Act, would give every district bank representative a vote in the FOMC. So do you feel that this policy will lessen the centralization in the Federal Reserve system?

Dr. BAKER. Oh, absolutely. Yes.

Mr. WILLIAMS. OK.

Second, I would like to ask you also about the proposal to restore Class A director voting rights in the selection of district banks presidents.

I agree with your testimony that section 1107 of Dodd-Frank, which took voting rights away from Class A directors, served only to increase the board's political influence over district banks. And since the change was made, unconventional candidates, as we all know, have been chosen to succeed their conventional predecessors.

So what is the danger in section 1107 of Dodd-Frank if Congress does not successfully restore voting rights to Class A directors in the district bank president selection process? And, second, will this proposal successfully restore the former balance?

Dr. MICHEL. Sir, I do think 1107 actually was a solution in search of a problem. And, yes, I do think restoring it is the right way to go.

I do think that some of the—without naming names, I think the goal should be to have people who understand their districts, understand banking in their districts, understand monetary policy in their districts, in those district bank roles. And I think this is probably the best way to go about restoring that, as opposed to getting some presidents that we got recently for more political reasons, which is inevitably what happens when somebody in Washington picks those people.

Mr. WILLIAMS. We have seen it, haven't we? Thank you.

Mr. Pollock, in your testimony, you spent some time discussing the checks and balances necessary for our constitutional Government. No part of the Government should be exempt from oversight, the Fed included.

Oftentimes, the Fed performs actions outside of its defined role of monetary policy, unaccountable to anyone. This needs to be changed. And by exercising the power of the purse and putting the nonmonetary policy functions of the Fed on appropriations, Congress can begin to rein in this out-of-control entity.

So, in your estimation, is the proposal a step far enough in the right direction to begin to make the Fed more accountable to Congress?

Mr. POLLOCK. Congressman, in my opinion, it is a definite step in the right direction, but more accountability would be desirable. And this committee has, in other contexts, discussed additional substantive accountability of the Federal Reserve with respect to its monetary and financial operations. I think that is a good idea.

As I have pointed out in my testimony, in the 1970's the Democratic Party worked very hard to try to make the Fed more ac-

countable to Congress. They were right. But we need to do it more effectively.

Mr. WILLIAMS. One more question to you Mr. Pollock in my remaining time. When dealing with the uncertainty of the economic and financial future, you also stated in your testimony that the promotion of intellectual diversification within the organization is important.

One of the proposals before us provides for at least two staff members to advise each member of the Board of Governors, independent of the Chairman's influence. It seems to me that the Fed Governors ought to have access to unbiased advice if they are to make proper, sound decisions.

So do you feel that the board has at times fallen prey to what I would call groupthink? And would this proposal help to promote the intellectual diversification that you feel is so important in dealing with uncertainty?

Mr. POLLOCK. I think it definitely would. And I think a problem recognized by people who are Governors, other than the Chairman, is this fact that the staff always devotes itself to the Chairman and the dominant agenda. And this would be a very good proposal, as I said in my written testimony.

Mr. WILLIAMS. Thank you for testifying.

And I yield back.

Chairman BARR. The gentleman's time has expired.

The Chair recognizes the gentleman from California, Mr. Sherman.

Mr. SHERMAN. Democracy is under attack. The battleground is this room. And it is under attack from both the left and right. The left wants to make sure that we empower entrenched bureaucracies and protect them from public input. The right says, let's democratize by giving more power to banks. And we need regional control; we need control outside of Washington. We need to make bank presidents control their regulation process and monetary policy. Democracy may prevail, but it doesn't look like it.

We are told that we don't want to politicize things. That is because the enemies of democracy don't dare claim that they are against democracy. They just say they are against politics. But politics is the only mechanism by which the voters of the country can influence or control public policy. So you are not against democracy as long as the people who are elected do not control Governmental policy. I suggest that the enemies of democracy ought to have the guts to come out and say they are against democracy instead of using the word "politicalization."

And as for the idea that we need local input, I couldn't agree more. Let's have a Class D vote that has 100 voters and have that be the 100 largest local labor union leaders. Why should banks control monetary policy when we are all talking about jobs? If we care about jobs and we want some entity other than Governmental officials to have input, why banks? They are not dedicated to jobs. Why not local labor leaders? They don't have to be national labor, not Washington, not the national—local labor union leaders ought to be in control, or the public elected officials and the President, who is elected by the public, should be in control. But for God's sake, why banks?

Now, Dr. Michel, you suggested that we have—I believe it was also Mr. Selgin—you suggested that we ought to have the FOMC rather than the Board of Governors empowered. Since that just empowers banks rather than the people of the country to a greater degree, couldn't we marry that with the idea that these local presidents of the Federal Reserve are selected by the President or selected by local assemblies of voters or selected by any mechanism that doesn't empower banks?

Dr. SELGIN. Yes, Congressman. Well, what I am arguing for and what I think the proposal is for is not giving more power to the FOMC than it has traditionally had—

Mr. SHERMAN. Well, you are going back to an antidemocratic tradition which, fortunately, we have moved away from. We took some power away from an entity that had bank control and moved it to a body selected by an elected President of the United States. So, out of a nostalgia for an antidemocratic institution, you are moving back to that.

Dr. SELGIN. Well, perhaps, but the only nostalgia I am referring to lasted up until October 2008, so it is not all that nostalgic. The FOMC had the complete responsibility for monetary policy until that date when—

Mr. SHERMAN. So, if we are going to do that, why not have an FOMC that is entirely reflective of a democracy? Why have bankers vote as opposed to people voting?

Dr. SELGIN. Well, let's understand—

Mr. SHERMAN. Or labor union leaders. I am willing to go with that too.

Dr. SELGIN. I remind you—

Mr. SHERMAN. I am looking for Republican support for that idea.

Dr. SELGIN. —with its existing structure, the FOMC gives an overwhelming advantage to the members of the appointed Federal Reserve Board, who have five—

Mr. SHERMAN. So we will have some democracy and some bank control. Why don't we do that for Members of Congress? Why don't we say that three-quarters of the outcome is determined by how the voters vote and then we have a separate caucus of bankers and they control one-quarter of the vote? Wouldn't that be a good way to depoliticize?

Mr. Pollock?

Mr. POLLOCK. Congressman, my suggestion is the people who really are elected by the people, namely the Members of Congress, are the responsible party for the definition and the management of money. And that is the way—

Mr. SHERMAN. But we can vote to move away from democracy by setting up a commission of labor union leaders or banks to be making Governmental decisions.

Mr. POLLOCK. Since labor unions are private—labor only represent about 7 percent, if I am right, of labor, I am not sure—

Mr. SHERMAN. Well, I am willing to create employee councils of other institutions, too, just as soon as I get a Republican cosponsor.

I yield back.

Mr. POLLOCK. And, Chairman, if I could just say, I love politics, and money is political.

I think you and I agree on that one, Congressman.

Mr. SHERMAN. I yield back.

Chairman BARR. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Oklahoma, Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman, and thank you for holding this hearing.

And, clearly, one of the few things that we all agree on in this room is that Congressional oversight of the Fed is important. And given the wide effect of Fed regulatory authority, it is important that Congress be informed when the Fed is considering new regulations.

And, to that end, I will formally introduce a bill to require the Fed's Vice Chairman for Supervision to include written testimony about any current or intended regulations before Congress. And, furthermore, my bill will ensure that testimony is given even if the Vice Chair position is vacant at the time of the appearance.

And I am pleased to note that, despite some differences on other proposals at this hearing, all of the witnesses seem to agree in their written testimony that my bill has merit.

Admittedly, it is a simple concept and idea, but I still would like to get your thoughts on that.

So, first, I turn to you, Mr. Pollock. I realize this is a straightforward idea, which raises a question as to why this has never been an official requirement before. In your testimony, you discuss the increasing power of the Fed. If my bill were enacted, what regulatory areas under the Fed's purview would be the most likely to show up in this new testimony, in your mind?

Mr. POLLOCK. Thank you, Congressman.

I think it is an important proposal and a good one. And the Fed has become, as I said in the testimony, a hugely powerful regulator. If you look at the history of the Federal Reserve, you find what I call Shull's paradox, after a great historian of the Fed, which is: The more the Fed screws up in each cycle, the more power it gets in the subsequent political development. And this proposal would address that.

I would guess that you would have to get a lot of reporting on the so-called systemic risk activities of the Federal Reserve, which is where, under Dodd-Frank, they had the biggest expansion of their power. And by being able to run the stress tests to test systemic risk, they can really, without limitation, put anything into those stress tests that they want and make it up as they go. I think the Congress would want to hear about just how that works and about the systemic risk ideas in general.

Mr. LUCAS. Dr. Michel, I would ask you the same question but would also be curious how, if at all, previous Fed rulemakings would have been different if there were a requirement to provide testimony to Congress. Any thoughts, intuitions?

Dr. MICHEL. Well, I think more public scrutiny is always better than less. And if the Fed is going to be involved in regulating and there is a vice chair in charge of supervision, yet that position is vacant and they are still regulating, then somebody should come up here and describe what is going on, what is coming down the pike, and so forth. So, yes, I definitely think that would be an important improvement.

I would really quickly throw out, though, that, first of all—well, everybody has left—but I have never said the Fed is not political. And I think that is the opposite; I think it is incredibly political. It is certainly not independent from politics. And one of the reasons is because it is regulating.

And, in fact, it shouldn't be regulating. It should not be. We don't need more than one Federal regulator. I know that nobody wants to go that far right now, but we already have more than one Federal banking regulator. We don't need the Fed doing it, especially not since they have control over the money spigot.

Mr. LUCAS. Thank you, Doctor.

With that, I yield back, Mr. Chairman. Thank you.

Chairman BARR. The gentleman yields back.

The Chair now recognizes the gentleman from North Carolina, Mr. Pittenger.

Mr. PITTENGER. Thank you, Mr. Chairman.

Thank each of you for joining us today and for your continued support to this committee.

Mr. Pollock, I would like to ask you a couple questions. You have served as a chief executive for a large organization, someone who is more familiar than most with how these leaders are nominated and appointed. Does it make sense for an organization to completely silence its shareholders while hiring its chief executive?

Mr. POLLOCK. Congressman, I don't think it does. As I look at the problem of electing the chief executive, you have to ask, what is the nature of a board of directors? And the board as a whole, in my judgment, should be doing that. Because all directors, even when you have special rules where some directors are elected in some ways and others appointed, all directors have exactly the same fiduciary responsibility to the organization. And one of those, one of the most important fiduciary responsibilities, is selecting the best chief executive you can.

Mr. PITTENGER. Yes, sir. Thank you.

To that end, would you just help clarify the role of the Class A director of the Federal Reserve banks and the role that they play, essentially?

Mr. POLLOCK. In my judgment, the role of a Class A director is exactly the same as the role of any other director. All directors on any board are equally and severally and jointly responsible for doing what is in the best interest of the institution and its mission. And to divide boards into various constituency representatives is a way to destroy the functioning of the board.

Mr. PITTENGER. Yes, sir. I concur.

As you would understand, the Federal Reserve's first mandate is, of course, to stabilize prices. Is there a stronger alignment of incentives in giving voice to people who make fixed-rate loans?

Mr. POLLOCK. I think that if you are in the business of making fixed-rate loans or dealing with money in any sense, obviously, you have a strong interest in the monetary unit and its integrity. And that is appropriately and rightly represented in the deliberations of both the banks and should be in the board.

Mr. PITTENGER. Just to confirm our thinking, if you were to buy stock in a company, would you be able to vote for the chief executive of your company?

Mr. POLLOCK. No. You would vote for the directors, and the directors would choose the chief executive.

Mr. PITTENGER. Thank you very much.

One last question for you. Should Class A directors have all of the rights and responsibilities of Class B and C directors?

Mr. POLLOCK. To repeat myself a little bit, Congressman, I think all directors do have and should have the same responsibilities and, more importantly, the same duties.

Mr. PITTENGER. I appreciate the clarification on that.

Mr. Michel, can Class A directors vote for their chief executive, or did Dodd-Frank silence them as owners of their respective district banks?

Dr. MICHEL. So section 1107 of Dodd-Frank removed that ability and slanted it toward, in my opinion, being handpicked from D.C. The district president would be handpicked from somebody on or connected to the board.

Mr. PITTENGER. Thank you.

As you know, the CHOICE Act and also the Senate's Economic Growth, Regulatory Relief, and Consumer Protection Act contains a regulatory off ramp. While the Senate bill's regulatory off ramp is much more limited than the CHOICE Act, it is clear that both the House and Senate see merit in this reform.

Do you think that an original capital election or a regulatory off ramp is a positive reform that will reduce firms' probability of failure in any consequent taxpayer bailout?

Dr. MICHEL. Oh, yes, absolutely. So I am very glad that they are in both bills. It wasn't advertised that way in the Senate bill, but it is an off ramp. And, in principle, it is really not that different from the one in CHOICE in terms of how it is actually put in place and who it applies to, although the CHOICE Act one, as you know, is broader.

The idea is very sound. A higher equity ratio means that the bank is going to be able to absorb more of its own losses, therefore lowering the probability of failure and the need for a bailout. So this is definitely a positive direction.

Mr. PITTENGER. Thank you.

Mr. Pollock, do you want to comment on that? You are nodding your head.

Mr. POLLOCK. I sat at this very table and testified in favor of the CHOICE Act and the off ramp, and I continue that support.

Mr. PITTENGER. I appreciate your support.

Thank you. I yield back.

Chairman BARR. The gentleman yields back.

The Chair now recognizes the gentleman from Ohio, Mr. Davidson.

Mr. DAVIDSON. Thank you, Chairman.

And I thank our witnesses. I really appreciate your expertise in this matter.

And as we talked earlier, we have several ideas under consideration, and one is to put nonmonetary policy functions of the Fed on budget. The Federal Reserve is, of course, accountable to Congress, and that really needs to mean more than coming and answering a few questions once a year.

And, Mr. Michel, if you could address some of the concerns I am just going to share.

Chris Dodd, Senator Chris Dodd, of Dodd-Frank fame, one of the primary architects, acknowledged prior to the law's passage that, in light of the Fed's dismal performance before and during the financial crisis, that granting it more regulatory authority was, quote, "like a parent giving his son a bigger, faster car right after he crashed the family station wagon." So he recognized that, but of course he blew right through his own advice and gave the Fed even more authority as a regulator.

I am particularly concerned with actions of the Fed as regulators, and I will share a story. Prior to even thinking I would be a Member of Congress, I was a business guy. And I had a banker come talk to me and say, "You have been growing at 20-plus percent in these manufacturing companies, maybe you should just grow at 5 percent and play more golf." I said, "Is that really what you want to do?" He said, "No, I want to loan you more money." "Well, why would you say that?" Well, because they wanted to treat, under Basel III standards, the line of credit as if it were fully utilized, when we were using only about a third. Well, of course that weakens the balance sheet.

These kinds of things have had an incredible impact on the growth rate in our entire macro economy. And so you would think, is there a law that was passed? Is this part of Dodd-Frank? No. This is simply the Fed acting as a regulator.

Rulemaking, which we have oversight and review of in other regulatory agencies. The Congressional Review Act lets us rescind bad policy. But the Fed is somewhat immune to any of our suggestions.

So could you address some of those concerns, sir?

Dr. MICHEL. Sure. I mean, these are many of the types of concerns that I have been writing about, though I didn't ever have as good of an example as that one. That is amazing.

For years, the idea that Congress should just delegate to the Fed, go ahead and take care of all this stuff, and somehow that was democratic and somehow that the Fed is accountable for what they are doing is insane.

They have gone much farther than they should have, and that is just my opinion, but this needs to be reined in in a way that there is less discretion and that they are focused on monetary policy and that no other regulator should have as much discretion to be able to do something like what happened to you.

And I have to say, again, the notion that somehow they are not politicized and that politics doesn't come into play here and that these decisions to take on these international agreements isn't political, that is absurd.

Mr. DAVIDSON. Thanks.

And, Mr. Pollock, maybe you could comment on how the Federal Reserve blends this sense of credibility as a monetary policy—of course we have to have an independent monetary policy—to blur the lines and say, but—acting as a regulator here. Could you comment on that?

Mr. POLLOCK. Thank you, Congressman.

In my view, the Fed should be independent neither as regulator nor as monetary manipulator or manipulator of credit allocation and asset prices.

I also would go further, perhaps, than the proposal as far as appropriations go. I don't see any reason we shouldn't appropriate all of the Fed's expenses, not just the nonmonetary ones, because every dollar, as I said in my testimony, the Fed spends is, in fact, a taxpayer dollar.

Mr. DAVIDSON. Yes. I appreciate that. And so that shows this is a more modest proposal. There would be some support for a stronger position. And this is hopefully something that can reach some bipartisan support. I was encouraged to hear Mr. Sherman, in his opening remarks, talk about some concern for the lack of accountability for Federal agencies to this body.

I guess in my last few seconds here I would like to just throw out there one of the concerns highlighted by the rulemaking activity on short-term credit. The other thing is, in their conduct of monetary policy, the Fed has been swapping short-term money for long-term money. And what has been the effect of that on the growth rate of our economy, in your assessment?

Mr. POLLOCK. Congressman, if I could try on that one, the clear effect has been that, de facto, it has radically shortened the maturity structure of the debt of the United States and made the expenses of the debt going forward very vulnerable to higher short-term interest rates.

Mr. DAVIDSON. Thank you.

My time has expired, and I yield.

Chairman BARR. The gentleman's time has expired.

The Chair recognizes the gentlelady from New York, Ms. Tenney.

Ms. TENNEY. Thank you, Chairman Barr.

And thank you to the panel for a really great discussion. I am also a small-business owner. I am going to talk about a couple other things, but I loved the conversation about we keep talking about democracy, but when you have centralized power, how can you have democracy? I keep thinking of Milton Friedman somehow.

But, anyway, I really wanted to talk about a couple pieces of legislation that I have that deal with the Federal Open Market Committee and the blackout period, which Mr. Michel referenced. And there seems to be some ambiguity between the Congressional Members about the Federal Open Market Committee and about monetary policy. And the current structure of the blackouts results in the Federal Reserve's staff and employees don't have access to Congressional briefings—or we don't have access—they are denying congressional briefings to us during these blackout periods.

And my legislation aims to codify the policy but also explicitly provides that it does not apply to the Fed's supervisory and regulatory powers, and to give us an opportunity to know what is going on with the Fed.

And I just wanted to—I know, Mr. Michel, you mentioned this in your comments initially, but do you believe that the legitimate Congressional accountability is compromised when Fed officials and staff refuse inquiries about supervisory and regulatory matters by invoking the blackout period surrounded by the Federal Open Market Committee? If you could just give me a quick explanation.

Dr. MICHEL. Yes. And it becomes a fig leaf of sorts that they can hide behind for no real reason to stall—at the very least, stall from giving Congress answers to questions that they deserve the answers to.

Ms. TENNEY. Right, so less transparency. So you would support us requiring them to give an opportunity to speak instead of hiding behind these blackout periods?

Dr. MICHEL. Yes.

Ms. TENNEY. Thank you.

Just to switch gears for a second, I want to talk about the ability of the Federal Open Market Committee's role in the interest on excess reserves.

Back in 2006, Congress passed the Financial Services Regulatory Relief Act, which authorized the Federal Reserve to pay interest on excess reserves at reserve banks. I know we had a little bit of discussion on this already. However, when the bill was amended, it allowed the Board of Governors, not the entire Federal Open Market Committee, to set the rates. The interest rate paid on reserves is set by the board and now serves as an additional instrument for conducting monetary policy. So the theory goes.

Let me ask—and I think I would just want to jump down and talk to Mr. Selgin. Would you be supportive of legislation to shift the responsibility to set interest rates on reserves from the Board of Governors to the FOMC so that the district bank presidents who are voting members of the FOMC would be able to participate in a process that has now become a central tool of this monetary policy that we have referenced today?

Dr. SELGIN. I would indeed, Congresswoman. I believe that the decision to place monetary policy decisionmaking with the FOMC, which was a decision that prevailed until recently, represented, itself, a very reasonable compromise between placing all power in the hands of the appointed board members and placing power in the hands only of the district banks, which is where it used to be before 1935.

So we had a nice compromise, a compromise that actually weighs in favor of the board. And now, inadvertently, the law has taken the compromise and undone it, giving all the power to the board. And this was inadvertent. Congress didn't intend this to happen. And I don't understand why Congress would allow it to continue this way, even though they didn't design it or intend it to happen in the first place.

Ms. TENNEY. Yes. And to reference Mr. Pollock saying, let's go back to having Congress exercise its full Article I, Section 8 powers over the Fed—so you agree that the full mix of having the FOMC, meaning including Board of Governors and regional banks, would be the better way to determine what the reserve rates are?

Dr. SELGIN. I do.

Right now, suppose that the FOMC as a whole voted for a 2-percent upper bound to the target rate but the board favored a 2.5—that is, the board members favored a 2.5 percent rate. Legally, the FOMC would have no power to prevail over the board in this case. Now, the board might listen to the Fed presidents, but it doesn't have to by law.

This is a very undesirable situation because it is unintentional and it undoes a compromise that was reached legally and understood by everyone to be reasonable in a manner that no one discussed or approved of or debated. And this is not how laws and how the Fed should be reformed. It should be reformed in this room deliberately, not as a matter of inadvertent developments outside of Congress.

Ms. TENNEY. Thank you very much.

My time has expired. Thank you.

Chairman BARR. The gentlelady's time has expired.

The Chair recognizes the gentleman from Indiana, Mr. Hollingsworth.

Mr. HOLLINGSWORTH. Well, good afternoon. I appreciate all of the witnesses being here.

And certainly much has been talked about with regard to accountability, all of which I agree with. That is the direction we need to move in, accountability to the people and, as Mr. Pollock said, perhaps not to the executive. There is a long, sordid past of central banks being accountable to executives that ends poorly.

But one other thing I wanted to talk about was a little bit about the underlying economics. And I know Dr. Selgin on several occasions has remarked about some of the grave deleterious effects of totally supplanting open market operations with IOER and IOR.

And I wondered if you might review a little bit of that with us, not the accountability and decisionmaking but just the underlying policy itself and some grave concerns surrounding that.

Dr. SELGIN. Yes. Thank you, Congressman, for the opportunity.

It is very odd that we got to this situation where interest on excess reserves has become our monetary policy tool. I want to remind the committee that, when the Fed implemented interest on excess reserves in October 2008, it was concerned that there might be too much inflation in the economy and wanted to make sure monetary policy wasn't too loose. Interest on excess reserves was designed to get banks to hoard all the fresh reserves the Fed was creating. And, in retrospect, it is pretty clear it contributed to the collapse of the economy that took place in the months after its implementation.

Yet, despite that collapse, the Fed decided to keep that mechanism, that instrument in place so that, even after it created several trillion dollars of fresh reserves through its quantitative easing, those reserves also piled up, as might have been expected, and the stimulus effect was less than it should have been.

Since then, the Fed has consistently failed, as has been mentioned, to reach its 2-percent inflation target. Well, don't you know? Maybe that has something to do with the fact that, no matter how many reserves banks get, they tend to just sit on them, or at least the bigger banks in New York and many foreign ones are sitting on them, where they cannot be serving the needs of the American economy, let alone contributing to an increased inflation rate.

Mr. HOLLINGSWORTH. Right.

And for the dozens of Americans watching this and keeping score at home, I think the summary is that, otherwise, these banks would be lending out to consumers, out to businesses, who could productively invest that capital, use that capital to grow the econ-

omy. Those reserves and excess reserves are now sitting at the Federal Reserve not creating economic growth. And that output gap that we have seen be very large over the last decade has ensued, leaving many of my constituents back home wondering about their financial future and their business's financial future.

Dr. SELGIN. Indeed.

If I may add to that, before the crisis—before interest on reserves, rather, banks lent approximately all of their reserves. That is, they held no excess reserves. So loans were about equal to 100 percent of the bank's assets, almost. After interest on reserves, excess reserves became 20 percent of bank's assets—

Mr. HOLLINGSWORTH. Right.

Dr. SELGIN. —and loans became 80 percent.

Mr. HOLLINGSWORTH. Right. I think many of my constituents would be shocked to learn, reading in the papers over and over again throughout the crisis and afterwards there is no loan growth and people aren't taking out loans, that we are here encouraging banks not to make loans by paying above-market interest rates on excess reserves parked at the Federal Reserve. And I think that they would be astonished to discover that.

I wanted to transition a little bit to a topic and maybe go back to the 30,000-foot level and talk overview. And I was going to ask you this, Dr. Michel.

The U.S. banking system has been especially prone to crises and volatility over the last 100 years, maybe even compared to our developed-world counterparts. And I was curious if you could talk a little bit about what your view is on how the Federal Reserve may or may not have contributed to some of that volatility over time in, as you said earlier, some of the politicization of decisions but also just some of the policies that they put in place maybe without some forethought as to how those might have impacts on the real economy.

Dr. MICHEL. Sure. It has contributed to a lot of volatility. It has a really great track record if you look at only the so-called great moderation and if you ignore everything else.

Mr. HOLLINGSWORTH. Right.

Dr. MICHEL. But, on the whole, the United States banking system has been the most volatile of pretty much any developed nation.

Mr. HOLLINGSWORTH. Right.

Dr. MICHEL. And the Fed has contributed to that mightily. I, personally, don't throw out the Great Depression. That was a pretty big one. That was a pretty big mistake.

Mr. HOLLINGSWORTH. Right.

Dr. MICHEL. And, ironically, they made almost exactly the same mistake in the last crisis by having the money supply tightened up too much at exactly the wrong time.

Mr. HOLLINGSWORTH. Right.

Sorry, I am running out of time. The last thing I wanted to ask you about was real GDP targeting. I know that you and I have talked about this on several occasions, but I know the Federal Reserve's first mandate, to maintain stable prices, has been talked about, that 2-percent growth in prices may or may not be stable.

Do you have a view on real GDP targeting versus what we are currently doing with the first mandate?

Dr. MICHEL. Yes, I think that would be a much better approach than either the dual mandate that we have or even just a single price stability target. It is more flexible, it is easier to implement in terms of the information that you need, and it is more forgiving.

Mr. HOLLINGSWORTH. Right. I appreciate that.

I yield back.

Chairman BARR. The gentleman's time has expired.

The Chair recognizes the gentleman from Minnesota, Mr. Emmer.

Mr. EMMER. Thank you, Mr. Chair.

Thanks to the panel for being here.

Very quickly, according to The Wall Street Journal, Lloyd Blankfein, Goldman Sachs' CEO, appears to see the considerable increase in bank regulation as a competitive advantage, observing that, quote, "more intense regulatory and technology requirements have raised the barriers to entry higher than at any other time in modern history. This is an expensive business to be in if you don't have the market to share in scale," close quote.

Mr. Pollock, we are all familiar with the term "too big to fail." Did Mr. Blankfein's comments suggest that recent financial regulations are encouraging banks to become too big?

Mr. POLLOCK. Congressman, I don't think there is any doubt about the fact that intense, complex, burdensome, expensive regulation favors big banks or big organizations of any kind versus small ones, because big organizations have the scale to build internal bureaucracies to set against the Government bureaucracies and little ones don't. So it is a tipping of the competitive advantage toward big organizations.

Could I make one comment—

Mr. EMMER. Please.

Mr. POLLOCK. —just to my colleague Mr.—your friend—

Mr. EMMER. Dr. Michel.

Mr. POLLOCK. —Dr. Michel. And that is, he gave the Fed credit for the "great moderation," which was really the great overleveraging leading to the disaster.

Dr. MICHEL. For the record, I just said they had a good reputation. I didn't say it was—

Mr. POLLOCK. Fair enough.

Mr. EMMER. So, that aside, if you go back to 2008, there were roughly a little over 8,000 community banks in this country, the mainstream banks that are basically the backbone of our small communities all across this country. And I know in our great State of Minnesota they are incredibly important to small-business creation, to entrepreneurs that have an idea and they are starting a business in their garage. And we have all kinds of examples; Medtronic is one that comes to mind in Minnesota.

Those banks—and I guess, Dr. Michel, since you were called out, did those banks cause—those community banks, did they cause the crash in 2008?

Dr. MICHEL. No, they didn't. And they are being punished for things that they didn't do with more regulation. And that is nothing new. This is a very long-term trend, as I am sure you are

aware of. This has been going on for decades, in terms of more regulation being hoisted on the banks, creating the incentive to get larger. And the flip side of that, of course, is that you are too small to succeed if you don't grow—

Mr. EMMER. Well—

Dr. MICHEL. —or merge.

Mr. EMMER. And if I can interrupt, because this is a great discussion. We never have enough time.

We seem to have some folks at the Fed who think the reason that we are losing these small banks—and you need every financial institution in the financial services food chain. And we seem to be sucking all the small ones up into the bigger ones, and creating this inverse pyramid that actually could set us up for a bigger problem in the future. But they will say to you things like, "Well, it is technology. The smaller banks can't keep up because of the technology."

I know it is more complicated than this, but isn't it a combination—and it involves the Fed, which we are trying to solve some problems, hopefully, in this Congress. Isn't it a bigger problem that every time there has been a problem with the financial system in this country, good-meaning people come in and give all kinds of new authority, maybe, or they look the other way and the Fed takes more authority, or other agencies, and they try to solve the problem but they squeeze down even harder on these smaller institutions that can't play? And then you have them keeping interest rates at zero for how many years so nobody can even make any money in the business.

I mean, isn't that the real problem for why you are killing the lower end of the financial services food chain in this country?

Dr. MICHEL. It is certainly accurate that they have been squeezed more for every problem that comes up. If you look at Basel, that is great example. The Basel requirements were forced on all banks. That is ridiculous. They were never meant to apply to any bank that is not internationally active.

Mr. EMMER. The First Bank of Hallock, for instance, doesn't really care what is going on overseas, right?

Dr. MICHEL. Right.

After the S&L crisis, from corrective action, things were changed again. Smaller banks got the brunt of that. And, frankly, the FDIC resolution process adds to the concentration as well.

Mr. EMMER. I am going to stick with you. I am sorry. We have something going. So I want to just—with the couple of seconds left—well, no, it is—the question I have for you, since Mr. Pollock called you out, the question I have for you is: In a democracy, in a society that is supposed to be a Government by the people, why wouldn't we want an institution like the Fed to be more transparent and more accountable?

Dr. MICHEL. I think we do want it to be more transparent and more accountable. I think that is exactly the way we should go. There should be no secrets there. This isn't dropping bombs on people. This is the economy. This is monetary policy, regulation. Everything should be out in the open.

Mr. EMMER. Thank you. And yet I think it has that effect on some people.

Thank you, Mr. Chairman.

Chairman BARR. The gentleman's time has expired.

The Chair now recognizes the gentleman from West Virginia, Mr. Mooney.

Mr. MOONEY. Thank you, Mr. Chairman.

So, in the discussion drafts today, I have a bill that regards transparency. I am a big believer in a voters' Government, knowing what Government is doing at all times. So my bill requires the Fed to post on a public website the annual salary and benefits of any employees whose salary exceeds that of a GS–15 Federal employee.

We also, in my bill, provide for at least two staff positions to advise each member of the Board of Governors. And so they answer to that Board of Governors member, hired by and answer to them, not the overall board but just to that Board of Governors member, and to be able to provide advice to that Governor independent of the Chairman's influence. Regardless of who the Chairman is or which politicians are in charge, we want these Governors to have independent analysis available to them. And we also subject the Fed employees to the same ethical standards as Securities and Exchange Commission employees.

So my question, to no one in particular, whoever feels most ready to comment on it: Do you believe that the members of the Board of Governors can actually participate in honest and thorough deliberation and provide critical feedback to rules from staff, the Chair, and the Vice Chair for Supervision, if they do not have their own economic and legal advisors in each Governor's office?

Sure, Mr. Pollock.

Mr. POLLOCK. I strongly support that proposal, Congressman, to give that staff for diversification of the thinking and the deliberations of the Federal Reserve. I also support the other provisions in your bill.

Mr. MOONEY. Thank you.

Dr. Baker?

Dr. BAKER. I would just very quickly say, I would say I would support the proposal with a couple reservations.

One is I think you may want to go somewhat higher up in terms of who has to make full disclosures, because the salaries do seem relatively low for a senior economist in Washington, D.C.

The other point is, as much as I do agree, I think it is a good idea to have two dedicated staff from my casual conversations with Governors over the years, they didn't feel that they lacked access. Now, that could just be who I happened to talk to, but they didn't feel they lacked access to Fed staff.

Mr. MOONEY. OK.

Dr. SELGIN. I had the opposite impression from various Fed bank presidents who I have spoken to over the years, that they could use some—

Mr. MOONEY. Additional staff? OK.

Dr. SELGIN. —extra staff for purposes of participating in the FOMC deliberations.

Mr. MOONEY. Thank you.

I do have another on a totally separate topic, and it is actually for you, Dr. Selgin, so if you could keep your mic on there. In your testimony, you mentioned the level of interest being paid on re-

serves. And so it is actually a three-part question. Let me ask the whole thing, and I will yield to you.

Is the level of interest being paid on reserves unlawful? That is, given the interest on both required and excess reserves stands above the Fed fund rates and overnight repo rates, isn't interest being paid on reserves above the general level of short-term interest rates? And if interest on reserves is above the general level of short-term rates, then doesn't it violate the 2006 authorizing legislation?

I yield to you.

Dr. SELGIN. So those are excellent questions. And I think that the answer is, if it ain't illegal, it ought to be. And the reason I am putting it that way is that, under the statute, the Fed has the right to define how the law should be carried out. And it has defined the general level of short-term interest rates to be something that could include its own discount or primary lending rate. And so it has gotten out of the letter of the spirit of the law, though it is conforming with what is, under current regulatory procedures, the letter of the law.

I think that the problem is the law itself was too vague. It should specify exactly and reasonably what the "general level of short-term interest rates" means, using market short-term rates that are truly short-term and that are appropriately low-risk. And, by that measure, the Fed is definitely breaking the law right now, if you use an appropriate market rate.

Mr. MOONEY. OK. Well, thank you.

And I am just going to make a commentary in the last 40 seconds that I have on another separate issue. I was very interested in Dr. Pollock's testimony, particularly about how the banks, the Treasury and the Fed Reserve banks are used to finance wars. You mentioned that in your testimony. I think the American public could learn a lot more and research that a lot more.

And you mention in here wars back from the founding of our country, Napoleon, King William's war on the continent. You talk about the First World War, the Korean War. And then you talk about President Nixon trying to push monetary actions for the coming elections. I seem to recall George Herbert Walker Bush commenting on the Clinton election in 1992, if the rates hadn't changed, it would have been a different election outcome.

I would love to see a separate paper just on that issue. Don't go off on all the—just specifically on that issue, how monetary policy and bank reserves are used politically for either wars or campaign purposes. And I would love to see that separately.

I yield back, Mr. Chair.

Chairman BARR. The gentleman yields back.

The Chair now recognizes the gentleman from Arkansas, Mr. Hill.

Mr. HILL. I thank the Chairman and the Ranking Member for this continued discussion on how we can make the Fed more accountable. And I appreciate the hard work of each member on their bills that we are discussing today.

I was thinking, Mr. Pollock, that your testimony smacks of economic historian, that that is clearly a driving interest of yours. And

so it made me just reflect on your knowledge of the Constitution. Is the Federal Reserve in the Constitution, Mr. Pollock?

Mr. POLLOCK. Not specifically, for sure.

Mr. HILL. And so, in 1913, the Federal Reserve Act was passed. Who passed that act?

Mr. POLLOCK. It was passed by the Congress of the United States and signed by President Woodrow Wilson.

Mr. HILL. Yes. And so then we amended it in 1935, I believe you said, and 1977 and 1978. Was Congress meddling in the independence of the Federal Reserve in 1935 and 1977 and 1978?

Mr. POLLOCK. In my opinion, Congress was carrying out its constitutional duties to oversee the Federal Reserve.

Mr. HILL. Yes.

And I assume you know that the Constitution has a section about the judiciary, right?

So the Judiciary Branch of the Government, is that an independent branch of the Federal Government?

Mr. POLLOCK. Yes, Congressman, it is.

Mr. HILL. So every year in Congress, we try to pass the Financial Services and General Government Appropriations Act. Are you aware that the Judiciary Branch of the Government is subject to appropriations in the Congress?

Mr. POLLOCK. As, in my opinion, it should be, Congressman.

Mr. HILL. Do you feel the Judicial Branch lacks independence because of that?

Mr. POLLOCK. No, I do not.

Mr. HILL. I appreciate it.

I yield back the balance of my time.

Chairman BARR. The gentleman yields back his time.

And with the indulgence of the panel, I may embark on one additional round of questioning. And if any other Members want an additional round, I will be happy to recognize them as well.

I may not take the full 5 minutes, but I do want to discuss the legislative proposal that is in front of us relating to changing the voting rights of all of the FOMC members to an annual basis.

As you know, under today's anachronistic voting rotation, the FOMC policymaking occurs with some Federal district banks voting once every 3 years, others voting every year, specifically New York, and then two: Chicago and Cleveland, every other year. And that is the rotation of the district bank presidents. Of course, as you know, the Board of Governors are voting all the time.

And the proposal before us would change that so that every district bank president would be voting, have full voting rights every year all the time, just like the Board of Governors, the Governors, would continue to have their voting rights. And so all members of the FOMC would actually be voting on monetary policy decisions at all times.

Let me ask, Mr. Pollock, how did the current voting rotation of—and I am asking you to be a bit of a historian here. How did the current voting rotation of district bank presidents come into being? Is it possible that economic changes across these districts over time has made that rotation especially anachronistic?

And if the current rotation is less than representative, by giving an outside voice to certain economies and a larger-size voice for

other economies, why wouldn't we want to give each district a vote in every meeting?

Mr. POLLOCK. Mr. Chairman, to begin by answering the question at the end, I think we should.

The Federal Reserve Act originally in 1913 did not have an Open Market Committee provision in it. The Open Market Committee was invented by the Federal Reserve banks during the 1920's as a committee of the banks themselves when they found out that they could do things in the Government bond market which weren't originally thought of in the act.

In 1935, as part of the centralization of the Fed pushed by Marriner Eccles, because he was a powerful personality and he wanted to run it, they made the Federal Open Market Committee into statute with the voting that we have now. Of course, Cleveland and Chicago arguably had a much more powerful economic position at that point than now. And New York has its continued position as a financial center, but I don't think we really want a Washington-New York axis. A whole-country representation would, in my opinion, be better.

I just want to say, when it comes to voting, if you are afraid that the presidents would out-vote 7 Governors, if the presidents voted 9 against and 3 for and all the Governors voted in favor, the Governors would still win 10-to-9 under the proposal. You would have to have 10 banks voting against, out of 12, to defeat a unified board. And I think if you had 10 Federal Reserve banks opposing a proposal, you should really think carefully and withdraw it for more discussion in any case.

Chairman BARR. Thank you for that.

And, Dr. Selgin, I will ask you to comment on that as well. And, as you do, I will just bring to your attention the fact that—and it will probably not surprise anyone here—that Governors—and I will preserve their anonymity—have pushed back on this concept with me and others Members of Congress, and they have made the argument that the current system works pretty well the way it is and that it is a balanced system the way it is.

What is your response to that line of critique?

Dr. SELGIN. Well, my response would be that some people have a different idea of what it means for an institution to be working well than others and that I think that the presumption that we can't improve the working of the Fed reflects a great deal of optimism or perhaps a great deal of complacency upon anyone who holds it.

As for the current composition of the FOMC, it seems to me that among the more obnoxious particulars of that is the fact that the New York Fed has a constant representation on that board, whereas the other regional banks only have occasional representation. This truly is anachronistic. It dates back to the days before the 1935 act, when New York exercised a great superiority of influence compared to the other banks, though somewhat unofficially.

The problem that many people recognize with the overarching influence of certain segments of the banking industry on the conduct of Federal Reserve policy is chiefly a problem of Wall Street influence. It is not a problem of influence of bankers in other parts of the country.

So, if you are concerned about that, let's change this provision of the law dictating who is on the FOMC.

Chairman BARR. My time has expired. Thank you for your answers.

And I will now recognize the Ranking Member for an additional round.

Ms. MOORE. Well, Mr. Chairman, I would like to use my time to enter a couple more letters into the record: A letter from the Conference of State Bank Supervisors, which is a nationwide organization of banking regulators in all 50 States, American Samoa, D.C., Guam, Puerto Rico, and the Virgin Islands.

They object to the portions of section 1 of the draft that would impose a tax on State-chartered banks. They argue that small banks, the smallest State-chartered community banks would be hit the hardest since they will be required to pay the same fee as larger banks.

Also, I would like to enter into the record—

Chairman BARR. Without objection.

Ms. MOORE. —a letter from the Center for Popular Democracy's Fed Up coalition. They specifically object to the presidents of all 12 regional reserve banks being made permanent members of the Federal Open Market Committee.

And so, without objection, I would hope that you would enter that into the record.

Chairman BARR. Without objection.

Chairman BARR. The gentlelady yields back.

The Chair now recognizes the gentleman from Ohio for another round.

Mr. DAVIDSON. Thank you all. And thanks for the opportunity to ask some additional questions.

And, Dr. Michel, as I was referencing earlier, in the rulemaking practice of the executive branch, there is a pretty established protocol. And some would hope for even more transparency there, but there is a path where they publish a rule, and there is a comment period.

Have you seen the Fed act as a regulator consistent with that? Is it transparent, how they make rules? Or do they take positions if banks, for example, have a line of questioning to say, hey, would this be permissible? Is it easy to get guidance from the Fed as a regulator?

Dr. MICHEL. I have heard a lot of horror stories that it is not. I know that there have been a lot of conflicts in the past, not from just hearsay. I know there have been a lot of conflicts between the Federal regulators, the Fed being at the heart of that.

I also know that they have gone off on their own and done a rulemaking on their own after doing a joint rulemaking that they decided they didn't like anymore. The high-quality liquid assets is the last one, the most recent one, that comes to mind.

And on top of that you have a supervisory problem, in that you have—it is widely discussed in the community, banking community, that the Fed supervisors will come in and say something. There is no statute, there is no guidance. They just decide that you can or can't do something, and they intimate that you can or can't do something, and then you can't do it.

Mr. DAVIDSON. Right.

So to highlight a couple practices, not that these were inherently Federal Reserve issues, but things that were creative, I will grant the prior Administration, creative, but things like redlining and Operation Choke Point, where, using the power of a regulator, they are basically saying, "Hey, we are concerned about your reputation, you can't bank these people," even though they have no debt, they simply want a depository account, and telling banks, "No, you have to keep this branch open," even though you lose money there, it has been robbed 10 times, and it is a bad investment, or you have to make a bad investment in order to make good ones in other markets.

There is a heavy hand of regulation that has been established in the past. And so, when those things happen, it is nice for Congress to be able to step in and interject. And I would make a persistent plea to our colleagues or counterparts over in the Senate to take action on the CHOICE Act and help us do bigger reforms.

And, Dr. Selgin, I guess, are there concerns that you have in the regulatory lane that Congress, were they able to do more than ask a couple questions a few times, would be able to provide guidance that is clearly within the lane. And as my colleague Mr. Hill highlighted, not only is the judiciary on appropriations, Congress gives them guidance on all sorts of things in a regular fashion.

Dr. SELGIN. I think the Congress ought to be able to ask the Fed about anything at any time. And I think it ought to be able to inform itself about the subjects of any inquiry it wants to undertake. I don't believe that any barriers to congressional inquiries concerning the Fed are appropriate. And I don't understand the opposition of Federal Reserve officials and others to improving the basis for congressional oversight. I understand it, rather. I understand it, but I see it as a foible rather than something defensible.

Mr. DAVIDSON. Well, in general, the regulatory approach for any executive agency or any autonomous agency is an executive action where they are implementing, and the rulemaking or legislating is done by this body, according to the Constitution.

So, Dr. Pollock, any closing thoughts on that?

Mr. POLLOCK. I do have one. Thank you very much, Congressman.

In the 1960's, on the 50th anniversary of the Federal Reserve, a Democratic Congressman, Wright Patman, held extensive hearings on the Federal Reserve and the ability of Congress to direct it. And he extracted the following testimony, which I think is excellent, from the then-president of the New York Federal Reserve Bank, who testified: "Obviously, the Congress, which has set us up, has the authority and should review our actions at any time they want to in any way they want to."

I think that sums it up pretty well, Congressman.

Mr. DAVIDSON. It sounds a lot like the Congressional Review Act. And putting them on appropriations would be a suitable way to make sure we have that capability.

Mr. Chairman, I yield.

Chairman BARR. The gentleman yields back.

And, with that and with the call of the votes, I would like to thank my colleagues for their thoughtful proposals for our consider-

ation today, and I would like to thank our witnesses for their testimony and their reaction to these proposals.

Without objection, all Members will have 5 legislative days within which to submit additional written questions for the witnesses to the Chair, which will be forwarded to the witnesses for their response. I would ask our witnesses to please respond as promptly as you are able.

Again, thank you to our witnesses for your testimony.

This hearing is now adjourned.

[Whereupon, at 3:50 p.m., the subcommittee was adjourned.]

A P P E N D I X

January 10, 2018

Testimony of Dean Baker, Senior Economist at the Center for Economic and Policy Research

Before the House Financial Services Committee

Subcommittee on Trade and Monetary Policy

"A Further Examination of Federal Reserve Reform Proposals"

January 10, 2018

I want to thank Chairman Barr and Ranking Member Moore for inviting me to testify before the subcommittee. The issue of reforming the Federal Reserve Board has been debated for the whole time I have been in Washington, and I appreciate the opportunity to share my views on the topic.

Before I address the specific proposals now being considered, I will give my view of the proper relationship of the Federal Reserve Board to the president and the Congress. I will then assess these proposals against that background.

The Federal Reserve System has an unusual status as being a mix of public and private entities. The governors are of course explicitly part of the public sector, as presidential appointees subject to congressional approval. However the twelve regional banks are private, being owned by the member banks in the district, who have substantial control over the district bank's conduct.

This structure was put in place more than a century ago to fit the politics and the economy of the time. It is inconceivable that anyone constructing a central bank today would use the same framework. The archaic nature of the Fed's design is perhaps best demonstrated by the distribution of the regional banks. Two are located in the state of Missouri. Meanwhile, the San Francisco region not only includes the whole state of California, but the rest of the west coast, and the states of Alaska, Hawaii, Nevada, Utah, Arizona, and Idaho, in all accounting for more than 20 percent of the nation's economy.

While there were reasons that a mixed public-private central bank and regulatory system may have made sense at the start of the last century, this is no longer the case today. The United States is the only major economy with this sort of mixed approach. The Bank of England, the Bank of Canada, the Bank of Japan, and the European Central Bank are all purely public entities. It is recognized that the conduct of monetary policy, along with the lender of last resort and regulatory functions of the central bank, are necessarily responsibilities of the government.

When the central bank is fully public, there is an appropriate concern about political influence. Few would want the party in power in either the White House or Congress to be using the Fed's power for narrow political advantage. For this reason, it is necessary that the Fed be to some extent insulated from political control. Other central banks in developed countries have been quite successful in bringing about this degree of insulation. While finance ministers and other government representatives necessarily have contact with central bank presidents and other bank governing officials, as well as

professional staff, there is little evidence that in recent decades they have managed to have the central bank alter its monetary policy for narrow political ends.

The structure of the Fed similarly provides substantial insulation from political influence. The long terms of the governors mean that they need not be concerned that their actions will anger an incumbent president or powerful members of Congress. They cannot be removed except for malfeasance. Looking back over the history of the Fed, most economists and economic historians would agree that the instances where the Fed may have acted to advance narrow political ends are extremely rare. Even in the cases that are most frequently cited, such as the decision by the Fed under Chair Arthur Burns to have accommodative policy prior to the 1972 election, are very much subject to debate over motives.

While there does not seem much basis for concerns that the Fed will act to support the political party in power, there is a real concern about a structure that gives the financial industry a direct voice in the conduct of monetary and regulatory policy through their control of the regional banks. This is really an extraordinary structure without any obvious parallels in our governmental system.

Both aspects of this relationship make little obvious sense. The financial industry certainly has useful insights on the conduct of monetary policy, but it makes no more sense to give them seats at the table than the manufacturing or tech industry. Monetary policy has an enormous impact on the national economy and affects every sector in it; there is no reason to believe that the perspectives gained from working in the financial industry are uniquely valuable.

Similarly, the idea that an industry would be able to pick its own regulator is truly extraordinary. It is understandable that industry groups will try to lobby and in other ways influence the decisions of regulatory bodies. The pharmaceutical industry places pressure on the Food and Drug Administration (FDA) to approve drugs more quickly, the telecommunications industry lobbies the Federal Communications Commission (FCC) for looser standards on universal service, but in neither case are they given a direct role in appointing their regulators. No one would suggest that Pfizer or Merck should be able to appoint a commissioner on the FDA or that Verizon and Comcast should select one of the members of the FCC. The Federal Reserve Board is unique in this way, as the member banks within a district largely have the ability to control the selection of the bank president who plays a direct role in both determining monetary policy and regulation of the banks within the region.[1]

Most of the efforts at reform of the Fed over the last four decades have been in the direction of making it more of a public institution answerable to Congress. For example, the Humphrey-Hawkins Full Employment Act of 1978 requires the Fed give semi-annual testimony to Congress reporting on its progress in meeting the employment and inflation targets set in the law. As a result of a 1993

[1] The Dodd-Frank financial reform bill did weaken the banks control by taking away the votes of the Class A directors, who are appointed directly by the member banks, in selecting a president. Nonetheless, they still are likely to control the process since the Class B directors, who have half the votes, are appointed by the Class A directors. This is of course one of the issues the subcommittee is now considering.

agreement between then Chair Alan Greenspan and Representative Henry Gonzalez, who was chair of House Banking Committee, the Fed now releases full transcripts of the Open Market Committee's meetings with a five year lag. And, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act sought to reduce the power of the banking sector in the regional Fed banks by taking away the votes of Class A directors in selecting the bank president.

It now appears that Congress is interested in going the opposite direction with this latest set of proposals. Instead of increasing the public accountability of the Fed and following the example of every other major central bank, several of these proposals seem designed to strengthen the power of private banks within the Fed, thereby reducing its accountability to democratically elected officials.

The move away from accountability to democratically elected officials would be understandable if there had been a track record of failure. The standard concern is that a central bank that is controlled by elected officials will likely be too tolerant of inflation, as it is pressured to have accommodative monetary policy in the period just before elections.

This clearly has not been a problem with the Fed in recent decades. Inflation has been at relatively steady and low levels for most of the last three decades. In fact, since the Fed officially adopted the 2.0 percent average inflation target in 2012, the core inflation rate has consistently been below this pace. In other words, if we view the 2.0 percent inflation target as a proper goal of monetary policy, the Fed has failed by having too little inflation, not too much. This raises the question, what is the problem that these new proposals are intended to fix?

Also, we do have a track record showing how bank presidents have voted on FOMC decisions. In most cases, most bank presidents do vote with the majority, since dissents are relatively rare. However the dissents by bank presidents have been overwhelmingly in the direction of tighter monetary policy, in pursuit of lower inflation at the expense of higher unemployment.

An analysis of every dissent by a bank president since 1993, when the minutes first started giving reasons for dissents, showed that in 64 of 72 dissents bank presidents were pushing for more contractionary monetary policy.[2] This meant they were either arguing for an interest rate hike when the majority wanted to hold rates steady or that they were arguing for holding rates steady when the majority supported a cut in rates.

Since inflation has been low and mostly below target for most of this period, while unemployment has been higher than levels consistent with full employment, the implication is that if bank presidents had more authority in determining the Fed's monetary policy over this period, they would have needlessly curtailed growth and cost workers' jobs. It is difficult to understand why Congress might view this as a positive outcome.

[2] Baker, Dean, Sarah Rawlins, and David Stein, 2017. "The Full Employment Mandate of the Federal Reserve: Its Origins and Importance," Washington, DC: Center for Economic and Policy Research and Center for Popular Democracy, available at http://cepr.net/images/stories/reports/full-employment-mandate-2017-07.pdf.

Specific Proposals Being Considered by the Subcommittee

With this as background, I will briefly address the seven proposals currently being considered by the sub-committee. My ordering follows the order used in my invitation letter rather than my assessment of their relative importance.

1) **Requiring salary information and financial disclosures for Fed officials whose salary exceeds that of a GS-15 federal employee and assigning at least two staff positions to each governor.**

This disclosure portion of this proposal seems largely unobjectionable, although the cutoff may be somewhat low. The Federal Reserve System's Board of governors is unquestionably a part of the federal government. For the reason the public should have the right to know both what high-level officials at the Fed are being paid and also be assured that they do not have any clear conflicts of interest that could affect their actions.

My concern is that the pay level is not especially high for an experienced economist working in Washington, DC. I assume that the intention is to require salary and disclosure information from the most senior staff who have an important role in advising the governors, not to harass mid-level staff whose work is largely directed by more senior staff and the governors themselves. For this reason, I would suggest a higher cutoff so that only the top level staff is affected by these requirements. I do not know enough about salaries at the Fed to recommend a specific cutoff, but I'm sure that the subcommittee could get this information.

Ensuring that each governor has at least two designated staffers to provide information seems like a reasonable use of resources. Since there are only seven governors and the chair already has designated staff, any additional commitment of resources would be minimal. From my understanding of the Fed's operations, the governors already have substantial access to information/advice from Fed staff, but I can't see any harm in requiring a minimum amount of designated personnel. It certainly would not be a major expense.

2) **Establishing a blackout period of one week for FOMC members for one week prior to a meeting and extending to midnight the day after a meeting takes place.**

The principle of having a blackout period before meetings and continuing after the meeting is a good one. This is already the current practice with the period beginning on the weekend before meetings, which are held on Tuesdays and Wednesdays, and continues through the following Thursday. The logic is that we do not want FOMC members to be dropping hints just before a meeting which could provide information that market actors can trade on.

While there is little reason to question the wisdom this practice, it is not clear why Congress would feel the need to extend it and to enshrine it law. At least based on what is publicly known, the Fed has been very responsible in not leaking items that could allow for profitable trading by connected individuals.

The one notable exception was a leak by former Richmond Bank President Jeffrey Lacker, which led to his resignation last year.

Here also, the question is what problem is this proposal meant to solve? This is an area in which the Fed has been acting responsibly. It's difficult to see why Congress would feel the need to micromanage its operations with this sort of rule. Furthermore, while it is not clear (at least to me) what the optimal length of a blackout period should be, it is important to recognize that there is a real cost to making it too long.

When unexpected events happen, the public, and certainly financial markets, welcome the opinions of the Fed chair and other members of the FOMC. With eight meetings a year and a blackout period that runs for a full ten days surrounding each meeting, this law effectively is requiring the Fed chair and other members of the FOMC to remain silent on key issues for 80 days of the year, or more than 20 percent of the time. That seems excessive. If there was evidence that the current blackout period is insufficient and has allowed for improper trading, then perhaps the requirement in this proposed legislation would make sense, but absent such evidence, it is difficult to see why Congress would feel the need to require this longer blackout period.

3) **Amending the Federal Reserve Act to bring the non-monetary policy related functions of the Fed under the general appropriations process.**

The Fed like other banking regulators has the authority to set its own budget from its income from services provided to the financial industry, and more importantly from the interest earned on assets purchased with Federal Reserve notes.

This authority does seem inconsistent with a public agency accountable to Congress. There is logic to the idea that we would not want the Fed budget to be subject to congressional whims, where budget cuts could be used to punish it for pursuing monetary or regulatory policy against the wishes of the majority in Congress. But this goal can be met by having multi-year appropriations from which Congress could not easily deviate. Establishing a formula for the Fed's budget, similar to what Congress did for the budget of the Consumer Financial Protection Bureau, could be a useful way to meet the twin goals of having spending set by Congress, while still keeping it insulated from political influence.

In this respect, it is worth noting that the Supreme Court relies on Congress for appropriating funding for its operations. To my knowledge, this funding has never been used as a tool for influencing court decisions. There is little reason to believe that subjecting the Fed's funding to congressional approval would interfere with its ability to pursue an independent monetary policy.

4) **Modifying the Federal Reserve Act to Allow Class A directors to vote for district bank presidents**

This proposal would reverse the provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act which takes away the vote from Class A directors on selecting district bank presidents. This provision of Dodd-Frank was put in place to reduce the power of the banks in selecting both their own supervisor and also a member of the FOMC. (The Class A directors are appointed by the member banks.)

As noted in my earlier discussion, it is very difficult to understand the motivation for reversing this Dodd-Frank provision as opposed to going further in taking away the power of the financial industry over the Fed. I could not imagine members of Congress suggesting that industry groups directly appoint their own regulators in any other sector of the economy. It is difficult to understand why they would somehow view it as appropriate in the case of the financial industry and the Fed.

It is also difficult to understand why they would think it appropriate to delegate a fundamental public responsibility – control of monetary policy – in part to the financial industry. As noted before, it makes no more sense to give the financial industry a direct role in setting monetary policy than the tech industry or the telecommunications industry. Monetary policy affects the whole economy; there is no obvious reason we should want to give the financial industry an outsized role in setting its course.

5) **Modifying the Federal Reserve Act to allow all district bank presidents to vote at every meeting**

If I understand the proposal by Representative Williams correctly, it calls for having all bank presidents vote at every meeting. (All the bank presidents are already present for the discussions that precede a vote, so the issue is not having the opportunity to benefit from their input.) This proposal again seems to go in the opposite direction of other central banks, and recent policy on the Fed, by taking a big step away from a democratically controlled central bank.

It is difficult to understand the motivation for a measure that would assign the bank presidents a majority voice in determining monetary policy. The problem is compounded if it is coupled with the proposal to restore the vote of the Class A directors in selecting bank presidents.

6) **Amend the Federal Reserve Act to require the FOMC to determine interest rates on balances held on deposit at the Federal Reserve System by member banks**

This proposal would take away the power of the governors to have control over the interest rate paid by on reserves and instead have it determined by the FOMC. This also seems to be an effort to move away from a Fed controlled by officials appointed through the democratic process to one in which the member banks have more voice. I have given reasons before on why I consider that to be a move in the wrong direction. However I will also point out that it is not clear what this provision is intended to accomplish.

The FOMC sets the target rate, which is the federal funds rate in overnight markets. The interest rate paid on reserves is simply the tool that the Fed uses to reach this target. So the FOMC is already fully involved in the key policy decision.

It may make sense to insist that the bank presidents have a voice in the mix of tools used by the Fed to reach this goal if there was some reason to believe that they had expertise in this area that the chair and the other governors lacked, however this hardly seem plausible. Furthermore, I am not aware of any evidence that the federal funds rate has diverged to any substantial extent from the policy rate set by the FOMC. Given that reality, it is not clear what the motivation would be for this proposal.

7) **Amend the Federal Reserve Act to require the Vice Chair for Supervision of the Board of Governors to testify twice a year before Congress**

This proposal is a useful supplement to the Humphrey Hawkins Act provision requiring the Fed Chair to testify biannually on the Fed's progress in meeting its goal of full employment. In effect, this would require the Vice Chair for supervision to provide comparable testimony.

The Fed has often neglected its regulatory responsibilities, a fact that became painfully clear during the run-up of the housing bubble and the subsequent collapse and the resulting financial crisis. This provision will help to give the Fed's regulatory responsibilities more visibility. It will also encourage Congress to focus more attention on the stability of the financial system and to take note of potential risks that have come to the Fed's attention.

While both Ben Bernanke and Janet Yellen have taken more of an interest in regulation as chair than did Alan Greenspan, and have mentioned risks on occasion in their testimonies, it would be helpful to have the Fed official most directly responsible for oversight give regular testimony. This is a very useful proposal.

Conclusion

This subcommittee is considering a wide range of proposals that would alter the structure of the Fed. Several are quite useful in increasing openness and accountability. However the ones which aim to give more control of the Fed in the hands of the banking industry, rather than officials appointed through the democratic process seem at odds with recent trends both in the United States and the rest of the world. It is difficult to understand the effort to privatize the conduct of monetary policy and to turn over control of financial regulation to the industry that is being regulated.

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CONGRESSIONAL TESTIMONY

Monetary Policy Reforms for 2018

Testimony before
Committee on Financial Services,
Monetary Policy and Trade Subcommittee
United States House of Representatives

January 10, 2018

Norbert J. Michel, PhD
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The Heritage Foundation

Chairman Barr, Ranking Member Clay, and Members of the Committee, thank you for the opportunity to testify at today's hearing. My name is Norbert Michel and I am the director of the Center for Data Analysis at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Good monetary policy helps Main Street America—its workers, retirees, and savers—by ensuring that the economy does not stall due to an insufficient supply of money, or overheat due to an excessive supply of money. To accomplish this task, the Federal Reserve needs to conduct its business in a neutral fashion, and be as transparent as possible to remain accountable to the public through their elected representatives. Congress can implement many reforms to improve transparency and accountability at the central bank. This testimony evaluates several legislative proposals that would improve transparency and accountability, thus leading to monetary policies that produce better economic outcomes for all Americans.

Interest on Reserves. In late 2007, the Fed began various emergency lending programs that increased reserves in the banking system. In 2008, the Federal Reserve implemented the first of several quantitative easing (QE) programs, purchasing large quantities of long-term Treasuries and mortgage-backed securities. These operations eventually expanded the Fed's balance sheet to include more than five times the amount of securities it had prior to 2008. Currently, the Fed holds $4.5 trillion in assets, consisting mainly of long-term Treasury securities as well as the debt and the mortgage-backed securities (MBS) issued by Fannie Mae and Freddie Mac.

These operations ultimately caused the Fed to create a new policy framework that replaced traditional market activity with bureaucratically administered interest rates. By paying billions of dollars in interest to large financial institutions to make it more attractive for them to place funds with the Fed than to lend in other short-term markets, this framework gives the Fed an abnormally large presence (by historical standards) in credit markets. The new policy structure is a dramatic shift from the past, making it very difficult for the Fed to adequately regulate the overall availability of credit in private markets without allocating credit to specific groups.

The Fed has begun to shrink its balance sheet, but the existing scheme ensures that it will maintain an abnormally large footprint in credit markets for years to come. Furthermore, Fed officials have not announced any plans to end the Fed's interest on reserve policies or its special reverse repurchase program. To normalize monetary policy, thus restoring the market forces that the Fed has displaced, the Fed has to shrink its balance sheet *and* end its new policy framework. To achieve this goal, Congress could implement the following policies.

- **Allow the FOMC to set Interest Rates on Reserve Balances.** The Federal Open Market Committee (FOMC), consisting of the Federal Reserve Board of Governors, the president of the New York Fed, and four of the remaining Reserve Bank presidents (on a rotating basis), is responsible for all monetary policy decisions. It follows that the FOMC should be responsible for policy decisions that concern monetary policy. However, current law requires the Board of Governors to set interest rates on reserve balances held at Fed district banks, even though this rate has

become a key monetary policy tool. At minimum, Congress should ensure that the full FOMC, rather than the Board, sets this rate.[1]

- **Require The Fed To Stop Paying Above-Market Rates On Reserves.** Current law authorizes the Fed to pay interest on reserves "at a rate or rates not to exceed the general level of short-term interest rates."[2] Nonetheless, the Fed has consistently paid rates on reserves higher than virtually all short-term low-risk rates available on the market for nearly the entire time it has paid interest on reserves.[3] Congress should clarify the statutory language that authorizes the Fed to pay interest on reserves, thus aligning the Fed's practice with the original intent of the law. In particular, Congress should clarify the meaning of "general level of short-term interest rates" so that the Fed can no longer pay above-market IOER rates. Though there is no uniform repo rate to use as a benchmark market rate, the Fed's broad Treasury financing rate is a reasonable benchmark rate.[4]
- **Prohibit Interest Payments on *Excess* Reserves.** Economists have long recognized that requiring banks to hold non-interest-bearing reserves acts as a tax on bank deposits and, therefore, on bank depositors. However, the same economic argument does not apply to banks' decisions to hold *excess* reserves. As the recent experience clearly shows, allowing the Fed to pay interest on excess reserves enhances the Fed's ability to allocate credit to specific entities rather than provide system-wide liquidity.[5] For all of these reasons, the central bank should not be authorized to compensate banks that choose to hold more than the minimum required reserve balances.

Restoring Federalism. The Federal Reserve System was designed as a decentralized group of 12 district banks with federal oversight. By the end of its first decade, the relatively weak Federal Reserve Board had asserted itself in many ways, diminishing the district banks' autonomy. In 1935, Congress replaced the original Federal Reserve Board with the Board of Governors, the Fed's existing governing agency of seven presidential appointees. At the same time, Congress created the FOMC to conduct monetary policy, and the FOMC has always consisted of all members of the Board of Governors plus five voting seats from the 12 district bank presidents. From inception, the New York Fed president has always had a voting seat, while the other four voting

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[1] Section 1009 of the Financial CHOICE Act (H.R. 10), passed by the House in 2017, makes such a change.
[2] 12 U.S. Code § 461 (b)(12)(A).
[3] Norbert J. Michel, "The Crisis Is Over: It Is Time to End Experimental Monetary Policy," Heritage Backgrounder No. 3262, November 9, 2017, http://www.heritage.org/monetary-policy/report/the-crisis-over-it-time-end-experimental-monetary-policy.
[4] Michel, "The Crisis is Over."
[5] Michel, "The Crisis is Over."

positions rotate among the remaining district presidents. These changes dramatically shifted the Fed's power structure to Washington and further centralized what was originally designed to be a decentralized agency, one that was compatible with American federalism. Congress could implement any of the following policy changes to shift towards a less centralized Federal Reserve and restore a system more compatible with American federalism.

- **Greater Voting Representation of District Banks at FOMC.** The most straightforward policy to lessen the centralization that has developed in the Federal Reserve system is to simply change the makeup of the FOMC so that it includes one representative from each district bank as well as all members of the Board of Governors. Another alternative is to increase the number of voting seats that district banks have on the FOMC to six or seven, thus giving the district banks more equal representation without shifting the majority to the district banks. In either case, Congress should remove the New York Fed's permanent voting seat on the FOMC, thus equalizing its position to that of other district banks.[6]
- **Restore Class A Director Voting Rights.** Prior to Dodd–Frank, all members of each Federal Reserve District Bank's Board of Directors voted to select their new bank president. Section 1107 of Dodd–Frank amended the Federal Reserve Act so that Class A directors—those selected by member banks to represent the stockholding banks—can no longer vote in the election of a new district bank president.[7] Now, only Class B directors, who are elected by member banks to represent the public rather than the stockholding banks, and Class C directors, who are selected by the Board of Governors to represent the public, can vote in the election.[8] This Dodd–Frank provision did not solve any existing problem or serve any material purpose other than to increase the Board's political influence over the District Banks. Congress should repeal section 1107 of Dodd–Frank, thus restoring Class A directors' authority to vote in the election of new district bank presidents.

Increasing Accountability and Transparency. Congress has delegated a great deal of authority to the Federal Reserve. To remain accountable to the public through its elected representatives, the Fed's operations must be transparent. Congress can enact, at minimum, any of the following proposals to increase the accountability and transparency of the Federal Reserve.

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[6] Section 1004 of the CHOICE Act (H.R. 10), for example, increases the number of voting seats for district banks from 5 to 6, and requires *all* the district bank representatives to rotate on the FOMC.
[7] 12 U.S. Code § 341.
[8] 12 U.S. Code § 302.

- **Place the Fed on Appropriations.** To conduct open market operations, the Federal Reserve buys and sells securities, thus funding its operations related to monetary policy. While it would make little sense for Congress to appropriate these funds, subjecting the Fed's non-monetary policy functions to the regular appropriations process is a perfectly reasonable change that would improve accountability and transparency for the Fed's operations. The Fed's regulatory procedures, for instance, would be more transparent if implemented through the regulator appropriations process.[9]
- **Clarify the FOMC Blackout Period.** To "facilitate the effectiveness of the Committee's policy deliberations and the clarity of its communications,"[10] existing Fed policy limits the extent to which FOMC participants and staff can speak publicly or grant interviews. Typically, the blackout period surrounds the FOMC meeting, starting the second Saturday preceding an FOMC meeting, and ending the Thursday following the meeting. The lack of statutory clarity could provide Fed officials with an opportunity to delay Congressional oversight requests. A straightforward fix is to amend the Federal Reserve Act to define the blackout period and to specify which types of communications apply.[11]
- **Requiring Testimony When Vice Chair for Supervision is Vacant.** Current law requires the Vice Chairman for Supervision to "appear before the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives and at semi-annual hearings regarding the efforts, activities, objectives, and plans of the Board with respect to the conduct of supervision and regulation of depository institution holding companies and other financial firms supervised by the Board."[12] Thus, current law leaves the Fed with a significant amount of discretion regarding what to include in the required Congressional testimony. Furthermore, when the Fed Vice Chair for

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[9] Section 665 of the Financial CHOICE Act *of 2016* places the Fed's prudential regulatory and financial supervision activities under the regular congressional budget process. Norbert J. Michel, "Money and Banking Provisions in the Financial CHOICE Act: A Major Step in the Right Direction," Heritage Backgrounder No. 3152, August 31, 2016, http://www.heritage.org/markets-and-finance/report/money-and-banking-provisions-the-financial-choice-act-major-step-the. Optimally, Congress would transfer the Fed's regulatory function to either the FDIC or the Comptroller. See Norbert J. Michel, "Improving Financial Institution Supervision: Ending the Federal Reserves Regulatory Role," Testimony before Committee on Banking, Housing and Urban Affairs, Financial Institutions and Consumer in the Protection Subcommittee, United States Senate on November 21, 2014, http://www.heritage.org/testimony/improving-financial-institution-supervision-ending-the-federal-reserves-regulatory-role.

[10] Federal Reserve, "FOMC Policy on External Communications of Committee Participants," January 31, 2017, https://www.federalreserve.gov/monetarypolicy/files/FOMC_ExtCommunicationParticipants.pdf (accessed January 5, 2018).

[11] Section 1002 of the CHOICE Act (H.R. 10) makes such a change.

[12] 12 U.S. Code § 247(b).

Supervision is unfilled, there is a significant gap in Congressional oversight of the Fed's regulatory functions. A straightforward approach to fixing these shortcomings is to require specific items in the Congressional testimony, such as an update on all pending and anticipated rulemakings, and to require an alternate Fed Board member to testify when the Vice Chair of Supervision remains vacant.[13]

- **Improve Disclosure of Staff Salaries.** The Federal Reserve has morphed into a financial regulator with a reach that goes beyond the traditional banking industry. As such, the Federal Reserve's employees should be held to disclosure and ethics standards similar to those of the Securities and Exchange Commission, the main U.S. securities regulator.[14]

This testimony has only discussed a handful of the ways that Congress can improve the functioning of the nation's central bank and its monetary policy, but it is critical that Congress undertake a far-reaching review of the Federal Reserve System. A central bank's policy failures are particularly damaging because money is the means of payment for all goods and services, and the Fed's track record is less than stellar.

The Fed's misguided policies have long distorted prices and interest rates, thus causing people to misallocate resources in ways that have exacerbated business cycles, and the Fed's regulatory failures have led to resource misallocation and increased moral hazard. Aside from these regulatory failures' contribution to the 2008 crisis, the Fed's monetary stance was too accommodative, thus fostering overinvestment in areas people would not have otherwise invested in, such as housing. After the crash, the Fed failed to supply enough money when it was most needed, contributing to one of the worst crashes and slowest recoveries on record.

The Fed's post-crisis policies have also contributed to interest rates on safe assets remaining at historically low levels, mostly harming retirees and others who depend on such assets for their income. Simultaneously, the Fed has been paying large financial institutions to refrain from lending to Main Street businesses by paying them risk-free interest to sit on cash. These policies may have artificially boosted equity prices, thus sowing the seeds for another major disruption that could further damage the retirement savings of Main Street's workers. The Fed has been able to conduct these experimental monetary policies largely because Congress has given the Fed so much policy discretion. To correct these problems, Congress must first recognize that the Federal Reserve is not an indispensable part of the economy.

Too many policymakers view the Fed as a temple of scientists who know exactly which dials to turn to speed up or slow down the economy at precisely the right time, even though there is more than enough evidence to question this idea. Indeed, the minutes of the Federal Open Market Committee (FOMC) meetings frequently contain a list of reasons to doubt this proposition. For instance, in July 2015, long after the financial crisis and recession had passed, the FOMC minutes reported that:

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[13] Section 1006 of the CHOICE Act (H.R. 10) makes such changes. Ideally, Congress would transfer the Fed's regulatory function to either the FDIC or the Comptroller, thus obviating the need for a Vice Chair of Supervision. See Michel, "Improving Financial Institution Supervision."

[14] Section 1007 of the CHOICE Act (H.R. 10) makes such changes.

> The staff viewed the uncertainty around its July projections for real GDP growth, the unemployment rate, and inflation as similar to the average of the past 20 years. The risks to the forecast for real GDP and inflation were seen as tilted to the downside, reflecting the staff's assessment that neither monetary nor fiscal policy was well positioned to help the economy withstand substantial adverse shocks. At the same time, the staff viewed the risks around its outlook for the unemployment rate as roughly balanced.[15]

So more than half a decade after it failed to prevent the worst economic slowdown since the Great Depression, the Fed still believed its monetary policies were unlikely to help the economy "withstand substantial adverse shocks." And the Fed's official view was that its economic forecasts were just as uncertain as they had been during the past two decades. These facts, along with the Fed's long-term track record, should put to rest the notion that the central bank can fine-tune the economy.

Congress has an obligation to oversee the Fed, and it is clear that the Fed has not, even according to its own projections, delivered on its economic promises. Congress should hold the Fed accountable, and ensure that it no longer has the discretion to "manage" the economy however it sees fit through some vague macroeconomic mandate. The following two reforms are examples of policies that Congress can implement to achieve this goal.[16]

- **End the Fed's broken lender-of-last-resort function.** Congress should prohibit the Fed from making emergency loans under Section 13(3) of the Federal Reserve Act and via the discount window. There is, in fact, no clear economic rationale for the Fed to provide direct loans to private firms, and the discount window is a relic of the Fed's founding.
- **Update the Federal Reserve's primary-dealer system.** The current primary-dealer framework was created in the 1960s when there were clearer advantages to having a centralized open-market system in New York. At the very least, expanding the participants in open-market operations would make the federal funds market less dependent on any particular institution. This type of reform would enhance the Fed's ability to provide system-wide liquidity, thus reducing the temptation to lend money to individual financial firms.

Conclusion

It is difficult to argue that the Fed's recent policy actions accomplished anything other than saving a favored group of creditors at the expense of all others. Rather than hold the Federal Reserve accountable for these mistakes, policymakers appear to have put even more faith in the Fed's ability to influence interest rates and inflation, tame business

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[15]Federal Reserve Board of Governors, Minutes of the Federal Open Market Committee, July 28–29, 2015, https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20150729.pdf (accessed June 23, 2017).
[16] For additional reforms, see Norbert J. Michel, "A Roadmap to Monetary Policy Reforms," Cato Journal, Vol. 35, No. 2, (Spring/Summer 2015), pp. 315-329, https://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2015/5/cj-v35n2-9.pdf (accessed January 5, 2018).

cycles, and ensure the safety and soundness of financial markets. Congress can implement many different reforms that help hold the Fed more accountable, thus ensuring that the Fed conducts its business in a more transparent, neutral fashion. This testimony evaluates several legislative proposals that would improve transparency and accountability of the Federal Reserve, thus leading to monetary policies that produce better economic outcomes for all Americans.

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Testimony of
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To the Subcommittee on Monetary Policy and Trade
Of the Committee on Financial Services
United States House of Representatives

Hearing on "A Further Examination of Federal Reserve Proposals"
January 10, 2018

Federal Reserve Accountability and Structure

Mr. Chairman, Ranking Member Moore, and Members of the Subcommittee, thank you for the opportunity to be here today. I am Alex Pollock, a senior fellow at the R Street Institute, and these are my personal views. As part of my many years of work in banking and on financial policy issues, I have studied the role and history of central banks, including authoring numerous articles, presentations and testimony regarding the Federal Reserve. Before joining R Street, I was a resident fellow at the American Enterprise Institute 2004-2015, and the president and CEO of the Federal Home Loan Bank of Chicago 1991-2004.

The proposals under consideration today are all parts of a timely and fundamental review of America's central bank. As Congressman Huizenga has rightly said, "With the Federal Reserve having more power and responsibility than ever before, it is imperative the Fed...become more transparent and accountable."

From James Madison, who wanted to protect the new United States from "a rage for paper money," to now, money has always been and is an inherently political issue, involving many questions which are not amenable to technocratic solutions, but require judgments about the general welfare. For example, Congress instructed the Federal Reserve in statute to pursue "stable prices." But the Federal Reserve decided on its own that the term "stable prices" means perpetual inflation--at the rate of 2% a year. This reasonably could be viewed as a contradiction in terms, but certainly raises the question: Who should have the power to make such judgments? The Fed by itself?

Under the current monetary regime, with the Fed as the creator of the world's dominant fiat currency, busy manipulating money, credit, and interest rates, we have experienced the great inflation of the

1970s, the financial crises of the 1980s, and the bubbles and financial crises of the 1990s and 2000s. (The outcome of the bubbles of the 2010s is not yet known.)

The problems are not due to bad intentions or lack of intelligence, but to the unavoidable uncertainty of the economic and financial future. Since this future is unknown and unknowable, the Fed is incapable of knowing what the results of its own actions will be. It will inevitably be faced with "conundrums" and "mysteries." Monetary manipulation always involves judgments, which can also be called guesses and gambles. How should the Fed be accountable for its various judgments, guesses and gambles, and to whom? And at the same time, how should it be accountable for how it spends the taxpayers' money and how it makes decisions?

I believe there are four general categories which should organize our consideration of today's draft bills. These are, along with the related drafts:

1. Accountability of the Federal Reserve

   -Bring the Fed into the appropriations process

   -Define the blackout period

2. Checks and balances appropriate to the Fed

   -Vice Chairman for Supervision's reports to Congress

   -Disclosures of highly paid employees and financial interests

3. Centralized vs. federal elements in the Fed's structure

   -Revise the membership of the Federal Open Market Committee

   -FOMC to establish interest rates on deposits with the Fed

   -Modify appointment process for presidents of Federal Reserve Banks

4. Dealing with uncertainty

   -Staff for each Fed governor

<u>Accountability</u>

The power to define and manage money is granted by the Constitution to the Congress. There can be no doubt that the Federal Reserve is a creature of the Congress, which can instruct, alter or even abolish it at any time. Marriner Eccles, the Chairman of the Fed after whom its main building is named, rightly described the Federal Reserve Board as "an agency of Congress." As the then-president of the New York Federal Reserve Bank testified in the 1960s, "Obviously, the Congress which has set us up has the

authority and should review our actions at any time they want to, and in any way they want to." He was right, and that is the true spirit of "audit the Fed."

To whom is the Federal Reserve accountable? To the Congress, the elected representatives of the People, for whom the nature and potential abuse of their money is always a fundamental issue.

It is often objected that such accountability would interfere with the Fed's "independence." In my opinion, accountability is an essential feature of every part of the government, which should never be compromised. If accountability interferes with independence, so much the worse for independence.

In any case, the primary central bank independence problem is independence from the executive, not from the Congress. The executive naturally wants its programs and especially its wars financed by the central bank as needed. This natural tendency goes far back in history. The deal which created the Bank of England was its promise to lend money for King William's wars on the continent. Napoleon set up the Bank of France because "he felt that the Treasury needed money, and wanted to have under his hand an establishment which he could compel to meet his wishes."

The Federal Reserve first made itself important by helping finance the First World War. To finance the Second, as a loyal servant of the Treasury, the Fed bought all the bonds the Treasury needed at the constant rate of 2 ½%. The Fed's desire to end this deal with the Treasury in 1951, six years after the world war ended, gave rise to a sharp dispute with the Truman administration. That administration was by then having to finance the Korean War, a war that wasn't going so well. For his role in making the Fed more independent of the Treasury, Fed Chairman William McChesney Martin was considered by Truman as a "traitor." Two decades later, Fed Chairman Arthur Burns was famously pressured by President Nixon to match monetary actions to the coming election. Burns was marvelously quoted as saying that if the Fed doesn't do what the President wants, "the central bank would lose its independence."

The Federal Reserve Reform Act of 1977 and the Humphrey-Hawkins Act of 1978 were attempts under Democratic Party leadership to make the Fed more accountable to Congress. I think it is fair to say these attempts were not successful, but instead led principally to scripted theater.

The most fundamental power of the legislature is the power of the purse. If Congress wants to get serious about Federal Reserve accountability, it could make use this essential power. Every dollar of Fed expense is taxpayer money, which would go to the Treasury's general fund if not spent by the Fed on itself. Since it is taxpayer money, the proposal of one draft bill to subject it to appropriations like other expenditures of taxpayer funds makes sense. The draft limits the expenditures so subject to those for non-monetary policy related costs. In fact, I think it would be fine to subject all Fed expenses to appropriations.

A second draft bill defines blackout periods for communications from the Fed, including communications to Congress, around Federal Open Market Committee meetings. The draft would precisely set the blackout period as a week before and a day after the relevant meeting. This certainly seems a reasonable definition.

Checks and Balances

Checks and balances are essential to our Constitutional government, and no part of the government, including the Federal Reserve, should be exempt from them. But how should the Fed, so often claiming to be "independent," fit into the system of checks and balances?

The required appropriation of some or all of the Fed's expenses would be one way. Another way is additional required reporting regarding its regulatory plans and rules, since the Fed has amassed huge regulatory power. It tends to get more regulatory power after a crisis, no matter how great its mistakes and failings were beforehand, as it did after the last crisis, including getting a Vice Chairman for Supervision.

One draft bill requires that this Vice Chairman for Supervision, or others if the position is vacant, regularly report to Congress in writing and in person on "the status of all pending and anticipated rulemakings." Given the increase of the Fed's regulatory power, especially its powerful role as the dominant regulator of "systemic risk," this seems appropriate.

Another draft bill would require disclosures regarding highly paid Federal Reserve Board employees (those making more than a GS-15). The draft also would require disclosures of financial interests. Federal Reserve actions and announcements are market moving events. Addressing potential conflicts of interest is a standard policy.

Centralized vs. Federal Elements of the Fed's Structure

The original Federal Reserve Act of 1913 tried to balance regional and central power. Hence the name, "*Federal* Reserve System," as opposed to a single "Bank of the United States." Carter Glass, one of the legislative fathers of the 1913 Act, it is said, liked to ask witnesses in subsequent Congressional hearings: Does the United States have a central bank? The answer he wanted was "No, it has a federal system of reserve banks."

This theory lost out in the Banking Act of 1935, when power in the Fed was centralized in Washington, as promoted by Marriner Eccles (who still knew, as noted above, that the Federal Reserve Board is "an agency of Congress").

Centralization in the Fed reached its zenith with the elevation of the Fed Chairman to media rock star status, as in the title, "The Maestro." Some adjustment back to more dispersed power within the Fed arguably would make sense. Three of the draft bills move in this direction.

The first would expand the membership of the Federal Open Market Committee to include the presidents of all the Federal Reserve Banks, instead of five of them at a time. Since all the presidents already attend and participate in the discussions of the committee, the old voting rule does seem pretty artificial, especially since the Committee by and large operates on a consensus basis. If some proposal of the Chairman and the Board of the Fed were so controversial that it was opposed by a super-majority

of the presidents, such a proposal surely would deserve additional consideration rather than implementation under the old voting rules.

A second draft bill would make the FOMC responsible for the setting the interest rate on deposits with Federal Reserve Banks. Since this interest rate has now become a key element of monetary policy, placing it with related monetary decisions is quite appropriate.

A third draft in this area would return the election of Federal Reserve Band presidents to the whole Board of Directors of the bank in question. This reflects the principle that in every board of directors, all directors, however elected or appointed, have the same fiduciary responsibilities. The Board of Governors will continue to appoint one-third of the directors of each Federal Reserve Bank.

Dealing with Uncertainty

I have asserted the essential uncertainty characterizing Federal Reserve decisions. One approach to uncertainty is to promote intellectual diversification within the organization rather than a party line.

The staff of a body like the Fed naturally tends to be focused on serving a successful, powerful and dominant chairman. This risks promoting group-think. A well-known problem for the other Fed governors is lack of staff support for other directions they may want to investigate or pursue.

A good provision of the draft bills is "Office staff for Each Member of the Board of Governors," which would provide each non-chairman governor at least two staff assistants. It seems to me this might provide these other governors greater ability to pursue their own ideas, theories and research, and thus allow them to be more effective members of the Board and potentially provide greater intellectual diversification to the Fed's thinking.

In sum, the Federal Reserve without question needs to be accountable to the Congress, be subject to appropriate check and balances, and be understood in the context of inherent financial and economic uncertainty. It would benefit from rebalancing of centralized vs. federal elements in its internal structures.

Thank you again for the chance share these views.

Testimony
Before the U.S. House of Representatives Committee on Financial Services
Subcommittee on Monetary Policy and Trade
Hearing on "A Further Examination of Federal Reserve Reform Proposals"

George Selgin
Director, Center for Monetary and Financial Alternatives, Cato Institute

January 10, 2018

Introduction

Chairman Barr, Ranking Member Moore, and distinguished members of the Committee on Financial Services Monetary Policy and Trade Subcommittee, my name is George Selgin, and I am the Director of the Cato Institute's Center for Monetary and Financial Alternatives. I am also an adjunct professor of economics at George Mason University, and Professor Emeritus of Economics at the University of Georgia.

I'm grateful to you for allowing me to take part in your consideration of various proposals for reforming the Federal Reserve System. With your permission, I wish to limit my testimony to one only of several proposals being discussed at today's hearing, namely, the proposal to make the FOMC, rather than the Federal Reserve Board of Governors, officially (and not just informally) responsible for setting the interest rate paid on banks' excess reserve balances.

Monetary Policy Authority before Interest on Reserves

Between the middle of the Great Depression and the recent financial crisis, responsibility for determining the stance of monetary policy has rested mainly, if not exclusively, with the Federal Open Market Committee, a twelve-member committee consisting of the seven-member Federal Reserve Board of Governors plus five of the twelve Federal Reserve Bank presidents, always including the president of the New York Fed, with the remaining four bank presidents serving on a rotating basis.

Title II of the Banking Act of 1935 (U.S. Code § 263) amended the Federal Reserve Act by creating the FOMC and vesting it, rather than either individual Federal Reserve regional banks or the Federal Reserve Board of Governors, with the authority to "consider, adopt, and transmit to the several Federal Reserve banks, regulations relating to the open-market transactions of such banks." The amendment also stipulated that the Fed's open market operations "shall be governed with a view to accommodating

commerce and business and with regard to their bearing upon the general credit situation of the country."

The new arrangement essentially ended individual Federal Reserve banks' power to independently influence the stance of monetary policy. Whereas until 1935 each Fed bank was in charge of open-market operations within in its own district, in the new set-up, instead of pursuing their own, independent policies, "the district banks participated in the creation of a coordinated, national monetary policy."[1] This outcome reflected a compromise between those who would have preferred, and those who feared, the complete centralization of control over monetary policy in Washington.

Strictly speaking, the 1935 legislation did not give the FOMC exclusive control over monetary policy. While it gave that committee complete authority over open market operations, it placed control over two other instruments of monetary policy—changes in banks' minimum reserve requirements and Fed banks' discount rates—with the newly established Board of Governors of the Federal Reserve System.[2] However, these other monetary policy instruments have since fallen into desuetude. Regarding reserve requirement changes, by 1954 the Board had concluded that

> Frequent changes in requirements even by very small percentage amounts would be disturbing to member banks and to the credit market. For these reasons this method of influencing bank reserve positions and the flow of credit and money is usually employed only when large-scale changes in the country's available bank reserves are desired. For day-to-day operations in influencing the flow of credit and money, the Federal Reserve depends principally on the more flexible instruments of discount and open market operations.[3]

Discount rate adjustments, in turn, became unimportant in influencing the stance of monetary policy when the Fed switched from reserve targeting to targeting the federal funds rate during the 1980s. Since 2003, moreover, the discount rate has been set above the fed funds target (or, since November 2008, above the upper bound of the fed funds

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[1] See Gary Richardson, Alejandro Komai, and Michael Gou, "Banking Act of 1935," Federal Reserve Bank of Richmond *Federal Reserve History* website, https://www.federalreservehistory.org/essays/banking_act_of_1935.

[2] Among its other provisions the 1935 Banking Act replaced the previous "Federal Reserve Board" with the present "Board of Governors of the Federal Reserve System." Although this change was at first largely cosmetic, after 1936 the Secretary of Treasury and Comptroller of the Currency no longer sat on the Board, as they had done previously (the first of them as Governor or Chairman). Confusingly, the Board of Governors continues to be routinely referred to as the "Federal Reserve Board."

[3] *The Federal Reserve System: Purposes and Functions* (Washington, DC: Board of Governors of the Federal Reserve System, 1954 (https://fraser.stlouisfed.org/files/docs/historical/federal%20reserve%20history/bog_publications/bog_frs_purposes_1954.pdf).

target range). When the discount rate is above the effective fed funds rate, banks ordinarily have no reason to borrow at the discount window.

Consequently, for all intents and purposes, for several decades prior to October 2008, when the Fed began paying interest on banks' reserve balances, the FOMC – and the regional bank presidents taking part in it – exercised *exclusive* control over monetary policy. Moreover, as we shall see, Fed officials themselves now take for granted the FOMC's ultimate responsibility for the conduct of monetary policy.

Interest on Reserves transfers Formal Control over Monetary Policy to the Board of Governors

The 1935 compromise by which regional Fed bank presidents, through their participation in the FOMC, shared the legal authority to determine the stance of monetary policy with the Board of Governors, came to an abrupt—if generally unnoticed—end in 2008 as a result of the passage of the Financial Services Regulatory Relief Act of 2006 and the Emergency Economic Stabilization Act of 2008.

Section 203 of the 2006 Act allowed the Fed to begin paying interest on banks' reserve balances beginning on October 1, 2011. The 2008 Act advanced that date by three years, allowing the Fed to begin making interest payments as early as October 1, 2008. The Fed was authorized by these Acts to pay interest on both banks' required and their excess reserve balances. Importantly, the 2006 law assigned responsibility for setting both rates, not to the FOMC, but to the Board of Governors, and this provision remained unaltered by the 2008 law.

The Fed's immediate goal in securing the authority to start paying interest on banks' Fed balances in October 2008 was to prevent the crisis-related emergency lending it was engaging in at that time from driving the fed funds rate below the FOMC's then-chosen target of 2 percent. By paying interest not just on required but on excess reserves, the Fed could encourage banks to retain newly-created reserves that came their way, instead of lending them. Interest on excess reserves (henceforth IOER) was thus deployed early so that it might bolster the Fed's ordinary means of monetary control.

As the crisis continued, however, the IOER rate came to perform, not merely a supplementary role, but the lead role in the Fed's setting of monetary policy. Instead of relying on open-market operations to achieve a target federal funds rate, the Fed switched to a new "floor" operating system in which the IOER rate itself took the place of open-market operations as its chief instrument of monetary control. The basic idea was that, instead of loosening or tightening its policy stance by buying or selling securities in the open market (and thereby adding to or subtracting from the total *supply* of bank reserves) the Fed could loosen or tighten by influencing banks' *demand* for reserves. A

higher IOER rate would, other things equal, increase banks' demand for reserves, tightening credit by discouraging bank lending, while a lower one, by reducing banks' appetite for reserves, would loosen credit, encouraging them to lend more.

By keeping its IOER rate above corresponding market interest rates, as it has done since November 2008, the Fed has prevented additions to the supply of bank reserves from resulting in any general increases in the supply of credit. Instead, increases in total bank reserves were matched by roughly equal changes in banks' excess reserve holdings. Although the Fed could still purchase or sell assets on the open market, and although it did, in fact, ultimately undertake three rounds of Large Scale Asset Purchases, its open-market operations *ceased* to play their traditional role as the Fed's main instrument of monetary policy.

Thus the Fed's switch to an IOER-based operating system had the effect of transferring control over the Fed's monetary policy stance from the FOMC, where it had resided for decades, to the Board of Governors, which had previously exercised that control solely through its participation, together with several Fed bank presidents, in the FOMC.

A Change Not Anticipated by Congress

The just-described transfer of authority for conducting monetary policy, from the FOMC to the Board of Governors, had not been anticipated, and was certainly not intended, by Congress when it passed the 2006 Financial Services Regulatory Relief Act.

Instead, when Congress originally granted the Fed authority to pay interest on banks' Fed balances, it did so in order, as the Federal Reserve Board itself stated in its 2006 Annual Report, to "reduce unnecessary burden [sic] on banking organizations and improve operation of the financial system."[4] Interest payments on required reserves, the report said, would "remove a substantial portion of the incentive for depositories to engage in reserve-avoidance measures," allowing "the resulting improvements in efficiency [to] eventually be passed through to bank borrowers and depositors."

As for interest on banks' excess reserves, although the 2006 Act also granted the Fed the authority to pay such interest, the Fed at that time anticipated employing the IOER rate, not as its chief device for regulating the federal funds rate, and for thereby adjusting the Fed's monetary policy stance, but merely to serve as an above-zero *minimum* possible value for the effective fed funds rate, so as to limit that rate's potential volatility. Because the Fed's target fed funds rate would generally fall between that

[4] 93rd Annual Report: Board of Governors of the Federal Reserve System, 2006 (https://www.federalreserve.gov/boarddocs/rptcongress/annual06/sec2/c5.htm).

minimum value and the Fed's discount rate, open-market operations were to continue to serve as the Fed's primary monetary control instrument.

These originally-intended functions of interest payments on banks' reserve balances were reflected in the 2006 law's stipulation that interest on Fed balances be paid "at a rate or rates not to exceed the general level of short-term interest rates" – which stipulation was not altered by the Emergency Economic Stabilization Act. Had Congress intended to have the Fed employ the interest rate on banks' reserve balances as an instrument of monetary control, and certainly had it intended to have that rate serve as the Fed's *chief* instrument of control, rather than as a mere means for offsetting the reserve requirement tax, it would certainly not have placed such a limit on the rates the Fed was authorized to pay.[5]

The decision to make the Board of Governors, rather than the FOMC, responsible for setting interest rates on banks' Fed balances, which was also carried over from the 2006 to the 2008 Act, likewise reflected the originally-intended purpose of interest on reserves. Because such interest payments weren't intended to serve as a primary means of monetary control, vesting control over them with the Board rather than the FOMC was not seen as contradicting the spirit of either the 1935 Banking Act or subsequent developments that had left the FOMC exclusively in charge of determining the stance of monetary policy.

An Untenable Situation

When, at the Fed's urging, Congress passed the 2008 Emergency Economic Stabilization Act, allowing the Fed to immediately begin making interest payments on banks' reserve balances, it cannot possibly have anticipated that the Fed would end up treating those interest payments, not only as an additional instrument of monetary control, but as its *chief* instrument of monetary control.[6] Consequently, it was only inadvertently that Congress ended up transferring responsibility for monetary policy from the FOMC to the Federal Reserve Board, thereby denying to the regional Fed banks the influence they had long exercised, at least to some extent, in shaping the course of monetary policy.

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[5] Since October 2008 the Fed has evaded the prescribed rate limit by allowing the Fed's own primary credit (discount) rate to represent "the general level of short-term interest rates" (see Regulation D (Reserve Requirements of Depository Institutions, 12 CFR Part 204). In fact, as a matter of policy, the primary credit rate is set well above market short term rates, so as to make it impossible for banks to borrow from the Fed's discount window for the sake of relending the borrowed funds at a profit.

[6] Thus the Federal Reserve's strategy for "normalizing" its policy stance has it doing so primarily by gradually raising the IOER rate, which defines the upper limit of the Fed's federal funds rate "target range," to just under 3 percent (https://www.federalreserve.gov/monetarypolicy/reqresbalances.htm).

It's true that the difference between control of monetary policy by the FOMC and control of that policy by the Board of Governors is not as great as it may seem. As Ben Bernanke has pointed out,

> The seven members of the Board (when all seats are filled) each have a permanent vote on the FOMC, whereas only five Reserve Bank presidents vote at each meeting. Moreover, in practice, greater sway over policy is held by the chair and those close to her, as well as by those Committee participants (even those without a vote at a particular meeting) who are most persuasive in the internal debates.[7]

Furthermore, Bernanke writes, although authority to set the IOER rate formally rests with the Board, "Fed policymakers know that the expectation of the Congress and the public is that monetary policy will be made by the FOMC, not the Board—an expectation reinforced by decades of Fed practice." Consequently there is no "risk that the Board will try to block implementation of an FOMC decision" (ibid.).

However, with all due respect to Mr. Bernanke, if both the public and Congress expect monetary policy to be made by the FOMC rather than by the Federal Reserve Board, then Congress has a duty to see to it that that expectation is fulfilled, not simply by counting on the Federal Reserve Board to fulfill it, out of a supposed deference to past experience, but by legally placing the power to make monetary policy where everyone agrees that it belongs. What's more, anyone familiar with the Fed's history during the last decade will have reason to question the assumption that "decades of Fed practice" supply a reliable guarantee of what the Fed may or may not do in the future.

The proposal now before your committee, to amend the Federal Reserve Act so as to make the Federal Open Market Committee rather than the federal Reserve Board officially responsible for regulating the interest rate paid on banks' excess reserve balances, would correct the present, anomalous state of affairs, legally ensuring that monetary policy decisions rest with the FOMC, and not the Board.

Better Still, Restore Interest on Reserves to its Originally Intended Purpose

I have argued so far that, *if* changes in the IOER rate are to continue serving primarily as a means for monetary control, *then* responsibility for setting the IOER rate should rest with the FOMC, which has traditionally been responsible for monetary policy, rather than with the Federal Reserve Board of Governors, the members of which have, traditionally, taken part in determining the Fed's monetary policy stance only by virtue of

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[7] Ben Bernanke, "The FOMC, the Board of Governors, and Fed interest rate policy." The Brookings Institution, *Ben Bernanke's blog*, Tuesday, June 9, 2015 (https://www.brookings.edu/blog/ben-bernanke/2015/06/09/the-fomc-the-board-of-governors-and-fed-interest-rate-policy/).

being permanent members of the FOMC, on which five regional Federal Reserve bank presidents also serve.

There are, however, grave problems with the Fed's new, IOER-based operating framework. As I have previously testified at length before this same subcommittee concerning those problems, I will not repeat that testimony or any part of it here.[8] I will only observe that those grave problems supply a powerful argument for compelling the Fed to return to relying on open-market operations, rather than changes in the interest rate paid on banks' excess reserve balances, as its preferred instrument of monetary control. That could either mean having the Fed revert to its pre-2008 operating system, or allowing it to implement the slightly modified version of that system that the 2006 Financial Services Regulatory Relief Act of 2006 was supposed to provide for, in which interest may be paid on banks' reserve balances, both required and excess, but only at rates low enough to discourage banks from amassing excess reserves. The same outcome might also be achieved by revising the current law to allow the Fed to pay interest on banks' *required* reserve balances only, but not on their *excess* reserves.

Should Congress choose to confine the Fed's interest payments as recommended here, those interest payments would no longer be capable of supplanting open-market operations as an instrument of monetary policy. Instead they would serve only to compensate banks for their reserve holdings, and perhaps to place an above-zero lower limit on the effective federal funds rate, without ordinarily encouraging banks to hold any excess reserves, and without becoming the chief means for regulating that rate—as was the original intent of the 2006 Act. *In that case* it would be perfectly appropriate for Congress to leave the Federal Reserve Board in charge of setting the rates paid on banks' reserve balances, though only assuming that the Board is no longer allowed to make a mockery of the stipulation that those rates not "exceed the general level of short term interest rates."

To rule out that possibility, Congress should consider amending the 2006 Act so as to give a precise meaning to the phrase "the general level of short-term interest rates." Given the statute's intent, the interest rates to which that phrase refers are presumably market-determined rates on instruments similar in duration and risk to the reserve balances on which the Fed is authorized to pay interest. Because reserve balances are themselves risk-free assets of zero maturity, private overnight repurchase agreements collateralized by Treasury securities are the closest private-market equivalents.

Although private overnight repo rates vary, the Federal Reserve Bank of New York has recently conducted extensive research aimed at establishing overnight repo

[8] I refer to my July 20, 2017 testimony at the Committee on Financial Services Monetary Policy and Trade Subcommittee Hearing on "Monetary Policy v. Fiscal Policy: Risks to Price Stability and the Economy" (https://financialservices.house.gov/uploadedfiles/hhrg-115-ba19-wstate-gselgin-20170720.pdf).

benchmark rates, using transaction level data. Based on this research, the New York Fed has developed a "Broad Treasury financing rate" that is very well suited to serve as an IOER benchmark rate, that is, as a reference "general" rate for the purpose of implementing the statute.[9] The 2006 statute could therefore be amended by having it define the "general level of short-term interest rates" as the average of the "Broad Treasury financing rate" over the 6-week period preceding any FOMC rate-setting announcement.[10]

However, until or unless the Fed's use of interest payments on banks' reserve balances can be confined as described—as long, in other words, as adjustments to those payments continue to serve as an important determinant of the Fed's monetary policy stance—the power to make those adjustments should rest solely with the FOMC, where it clearly belongs.

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[9] See https://www.newyorkfed.org/markets/opolicy/operating_policy_170524a and http://libertystreeteconomics.newyorkfed.org/2017/06/introducing-the-revised-broad-treasuries-financing-rate.html

[10] The proposed amendment might read as follows: "Section 19(b)(12) of the Federal Reserve Act (12 U.S.C. 461(b)(12)) is amended by inserting after Subparagraph (C): "(D) General level of short-term interest rates defined.—For purposes of this paragraph, the term 'general level of short-term interest rates' shall be defined as the average value over the preceding six-week interval of the Federal Reserve Bank of New York's benchmark Broad Treasury financing rate on overnight repurchase agreements."

AFR Americans for Financial Reform

Statement Re "A Further Examination of Federal Reserve Reform Proposals"
Hearing Before House Financial Services Committee Subcommittee on Monetary Policy
Wednesday, January 10, 2018

On behalf of Americans for Financial Reform (AFR), we are writing to state our opposition to legislative proposals that would end independent funding for Federal Reserve supervision and regulation and shift such funding into the Congressional budgetary process.[1]

Such a step would break with the long-standing precedent of independent funding for banking supervisory agencies, ranging from the Federal Deposit Insurance Corporation (FDIC) and the Comptroller of the Currency (OCC) to the National Credit Union Administration (NCUA). An important reason for this tradition is that independent funding protects key supervisory decisions about individual banks from direct political pressure through the budget process. This concern is particularly significant for the Federal Reserve, which is the key consolidated regulator for some of the largest and most powerful banks in the world.

Ending independent funding for Federal Reserve supervision and regulation would also be profoundly short-sighted. In 2017 the entire Federal Reserve system, including all regional Federal Reserve banks, spent less than $2 billion on bank supervision, regulation, and financial stability oversight.[2] The 2008 financial crisis cost the U.S. economy trillions of dollars in lost economic output alone, with total economic costs likely well in excess of $10 trillion.[3] These costs dwarf the expenditure on supervision and regulation intended to prevent the next crisis.

The Federal Reserve is the single most important financial stability regulator in the U.S. and perhaps the world. It exercises consolidated supervisory authority over the largest and most complex bank holding companies. Just the eight U.S. mega-bank holding companies designated as systemically significant to the global economy and supervised by the Federal Reserve hold over $11 trillion in assets, and have thousands of subsidiaries and business lines in dozens of countries. Again, Federal Reserve supervisory expenditures are very small compared to the size and complexity of this supervisory responsibility.

Ending the independence of Federal Reserve funding would not only expose supervisory decisions to additional political pressure from some of the wealthiest and most powerful global banks, it would create pressure to reduce the already limited Federal Reserve resources devoted to supervision and regulation. We urge you to oppose this step.

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[1] Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/.

[2] Federal Reserve budgetary data, available at https://www.federalreserve.gov/publications/2016-ar-federal-system-budgets.htm

[3] See Americans for Financial Reform, "The Costs of the Crisis", July, 2015, available at http://ourfinancialsecurity.org/wp-content/uploads/2012/09/CostCrisis2015July-Long-1.pdf

Economic
Policy
Institute
POLICY CENTER

Statement for the record
1/8/2018 hearing of the Monetary Policy and Trade Subcommittee of the Financial Services Committee:
"A Further Examination of Federal Reserve Reform Proposals"
2128 Rayburn House Office Building

To: Rep. Andy Barr, Chairman and Rep. Gwen Moore, Ranking Member of the Subcommittee on Monetary Policy and Trade

From: Josh Bivens, Ph.D., Research Director of the Economic Policy Institute (EPI)

The Federal Reserve is possibly the single most-important economic policymaking institution in the United States, if not the world. This makes questions surrounding its governance and structure crucially important for the economic prospects of typical Americans. Today's hearing addresses a number of proposals put forward to change the Fed's structure and governance. Given their importance, I would like to submit the following assessments of the proposed changes into the record.

A rough summary of the proposals is:

1. **Shift decision-making authority on interest paid on excess reserves from the Board of Governors (BOG) to the full Federal Open Market Committee (FOMC) FOMC**
2. **Modify provisions related to the FOMC "blackout" period**
3. **Require the Vice Chairman for Supervision to provide a written report on the status of all pending and anticipated rulemakings by the Board of Governors**
4. **Require the disclosure of staff salaries and financial information, and provide each Federal Reserve Board Governor with a dedicated staff**
5. **Increase the voting representation of district banks on the FOMC**
6. **Mandate the full participation of Class A directors in Reserve Bank board decisions, including the nomination of Reserve Bank presidents**
7. **Subject non-monetary policy related functions of the Fed to the regular appropriations process**

The proposals listed above range from non-objectionable to potentially problematic to clear degradations of the current quality of Fed governance. Below I group them and discuss their pros and cons.

Non-objectionable

Number 1 on this list - shifting responsibility for setting rates on interest owed on excess reserves (IOER) from the BOG to the full FOMC - seems non-objectionable. Whatever its other virtues or drawbacks, the interest paid on excess reserves is simply a tool for conducting monetary policy and control of interest rates. As monetary policy decisions over interest rates are set by the full FOMC, it is hard to see much virtue in having the BOG maintain the authority to change IOER unilaterally. The full FOMC has in the past shown great flexibility in being able to respond quickly to emergency needs to effect a change in monetary policy, so there seems to be no need to preserve the BOG authority over IOER for emergency reasons.

The proposed clarifications of procedures concerning the Fed's "blackout" period before FOMC meetings (**Number 2** on the list above) seem reasonable. There are decent reasons for the members of the FOMC to not make public statements immediately before a meeting, and the proposed provisions sensibly exempt the Fed Chair and allow them to speak publicly on monetary policy measures at any time. These seem like good-faith clarifications.

Similarly, having the Vice-Chair for Supervision responsible for providing a running written record of the status of pending and anticipated rulemakings of the BOG (**Number 3** on the above list) seems like a reasonable request aimed at increased Federal Reserve transparency. So long as those provision does not become subject to abuse and used to thwart or delay potential rulemakings, the call for transparency seems again seems to be a good-faith proposal.

Finally, the first part of **Number 4** in the list above - requiring the disclosure of staff salaries and financial information - seems reasonable. The Fed should be treated as a fully public institution, and salaries for other members of the Federal government are public knowledge. So long as the demand for "financial information" is not abused and used to make employment at the Fed seem unattractive or onerous, this should be a non-objectionable proposal to adopt.

Potentially problematic

Yet the second part of **Number 4** from the list above is potentially problematic. If the proposal is simply that current employees of the Fed can be tasked to specific members of the Board of Governors to staff their work, then that is reasonable - but not obviously different from the *status quo*. If instead this provision is meant to allow new Governors to bring in staff from outside the Fed and hop them over the Fed's normal employment placement procedures, this seems unwise.

Monetary policymaking should be a ruthlessly evidence-driven undertaking. Allowing new Governors to import in their own personal staff risks them bringing in their own echo-chamber of preconceptions and ideology. Instead, these preconceptions should be exposed to the evidence-based views of a professional and permanent Federal Reserve staff. Outside opinion

and analysis is always available to be tapped by Fed governors, so special provisions allowing new governors to bring their own preferred sources of outside opinion and analysis with them seem unnecessary.

Clear degradations of Fed governance quality
The remaining proposals should clearly not be adopted, as they would clearly degrade the quality of Federal Reserve governance.

Number 5 on the list of proposals would give every president of a regional Federal Reserve bank a vote on the FOMC. Currently, the New York Federal Reserve has a permanent vote on the FOMC, as does each member of the BOG, while 4 of the remaining 11 regional banks have a vote at any given time, with some banks rotating on and off at various points. This structure gives a majority to the BOG when it comes to setting monetary policy.

The greater power of the BOG relative to regional banks is appropriate. Members of the BOG are nominated by the President of the United States and confirmed by a majority of the U.S. Senate. In short, their selection contains some measure of public accountability. Regional Fed presidents, conversely, are simply chosen by their boards of directors. These boards are often over-weighted towards representatives from the financial and corporate sectors.

Some have objected to the characterization of regional Fed presidents as chosen by a fundamentally flawed governance structure, based on the clearly-admirable service of many of these regional presidents. And indeed, in recent years, some of the strongest evidence-based arguments for continuing to pursue genuine full employment have come from regional presidents.

But the excellent service provided by many of these regional presidents does not make the *process* that generated them less in need of reform. And while some regional presidents have done the job extraordinarily well, others have been the source of some of the weakest and evidence-lacking arguments about monetary policy in recent years. One high-profile case actually saw the Richmond Fed president leak information about an upcoming FOMC meeting to a financial firm.

Most importantly, the importance of Fed policy decisions means that we should not rely on a flawed system of picking regional Fed presidents and simply hope that excellent candidates will emerge time after time.

Fundamental reform of the Federal Reserve would demand it become a fully public institution (see Haedtler, Levin, and Wilson (2016) for more on making the Fed fully public). Until this fundamental reform happens, however, at a minimum the less-accountable regional presidents should not have their influence bolstered relative to the BOG.

Number 6 on the above list - mandating the full participation of Class A directors from regional Fed boards in all decision-making capacities - is particularly problematic. Class A directors on

regional Fed boards are chosen by the banks of the Federal Reserve district and are explicitly meant to serve as representatives of the financial sector on the boards. Class B and class C directors are supposed to serve the public interest (even though Class B directors are also elected by the banks of a Fed district). Having some key decisions made only by Class B and C directors is prudent - it's meant to put a buffer between the Federal Reserve banks and capture by the narrow interests of the financial sector. One would only support this proposal if one imagined that a pressing problem facing the Fed today is that big banks and financial institutions have insufficient opportunities to influence Fed decision-making. That is certainly not my view.

Finally, **number 7** on the above list - subject the Fed's non-monetary policy related functions to the appropriations process -- also seems like a clear degradation of Fed governance relative to the *status quo*. Currently, the funds needed to run and administer the Federal Reserve system are not subject to Congressional appropriation. Instead, the activities of the Fed generate profits. For example, when the Fed buys bonds, it receives the interest payments on these bonds. These profits even in normal years are far in excess of what is needed for Federal Reserve administration and activities, and so the Fed remits this excess to the U.S. Treasury. In recent years, as Fed profitability has soared as a byproduct of the extraordinary actions it took during and after the Great Recession, this excess has been even larger.

This independent financing source has helped preserve the Fed's independence from partisan political fights. This is not a theoretical concern; since 2010 the Fed has time and time again been subject to attacks from Congressional committees claiming that it has acted inappropriately in response to the crisis and that it needs to have its independent authority reined in. This critique of its performance since the financial crisis is clearly wrong, and a Fed that was unable to resist this pressure in recent years because it needed an annual appropriation from Congress would have almost certainly performed far worse.

This independent funding source is particularly important given the stepped-up role the Fed has taken as the lead regulator of the banking sector post-crisis. Recent decades have made clear the political power of finance to capture potential regulators. One key tool for effecting this capture could be convincing Congress to threaten to withhold appropriations for particular regulatory activities.

To be clear, the *status quo* gives the Fed enormous flexibility and independence far in excess of what most other government agencies have. But it needs unusual flexibility and independence. Further, while there have been many criticisms levied on the Fed's performance in recent decades (some valid and some not), there has not been (as far as I know) any accusation that they have mismanaged funds or engaged in lavish spending. If there is a desire to assert some greater transparency and accounting of the Fed's financial operations, one can imagine there are useful ways to do this.

But simply throwing the Fed's finances into the annual appropriations process would be a clear degradation in Fed governance. The claim that only the Fed's "non-monetary policy" activities

would be subject to appropriation seems like a meaningless distinction. To take the most trivial example, Fed research staff typically pursues independent projects as well as generating data and statistics to inform the work of the FOMC. Assessing what portion of each researcher's work went into a "non-monetary policy" tranche or not seems impossible.

Missing another chance to talk fundamental Fed reform

All in all, I'm afraid that today's hearing mostly misses another chance to talk about fundamental reforms of the Fed that would improve its governance and structure. When it was founded in 1913, the Fed was meant to tame the power of private financial institutions in the name of fostering broadly shared prosperity. It largely worked. But it needs to continue evolving, and the obvious next phase of this evolution is to become a fully public institution subject to democratic accountability throughout. For reforms in this vein, I would refer you to Haedtler, Levin, and Wilson (2016).

Thank you for the chance to share my views.

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Reference:

Haedtler, Jordan, Andrew Levin and Valerie Wilson. 2016. Making the Federal Reserve Fully Public: Why and How. Economic Policy Institute and Center for Popular Democracy.

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Date: January 10, 2018

To: Andy Barr, Chairman, Subcommittee on Monetary Policy and Trade
Gwen Moore, Ranking Member, Subcommittee on Monetary Policy and Trade

From: Jared Bernstein, economist, Center on Budget and Policy Priorities

Re: Bringing the non-monetary policy functions of the Board of Governors of the Federal Reserve System into the appropriations process.

Dear Reps Barr and Moore,

On two recent occasions, it was my privilege to testify before your subcommittee on the topic of legislation targeting various aspects of the operations of the Federal Reserve System. My theme was similar across both hearings: while the Fed is not perfect, it is a highly functional institution, efficiently providing key functions to our economy, including the pursuit of its dual mandate of price stability at full employment, and financial oversight of the banking system. The Fed's performance stands in contrast to other institutions within our political system that struggle to achieve the functionality so critical to the democratic process.

My testimonies argued that one reason for this efficient functionality is the Fed's political independence. In this regard, I warned that many of the proposals put forth by Republicans on this committee threatened that independence, and in so doing, threatened the smooth, non-partisan functioning of the central bank. This, in turn, creates threats to the functioning of not just the U.S., but the global economy.

I have similar concerns regarding many of the proposals in the discussion draft you are evaluating today. For example, the proposal to subject the non-monetary policy functions of the Federal Reserve to the congressional appropriations process is ill-advised and would unnecessarily threaten the independence and effectiveness of our central bank.

There are two fundamental problems with this proposal. First, and of greatest concern, the proposal would partially (for non-monetary functions) substitute the Fed's highly efficient, dependable self-financing system—the bank generates its own revenue through its open market operations—with a congressional appropriations process that has clearly been fraught with problems, delays, and uncertainty. It is no exaggeration to say that the Fed's self-funding mechanism has long been understood as a key component of its independence.

Second, there is simply no clear dividing line between monetary and non-monetary functions at the Fed. The Division of Research and Statistics, for example, would likely be categorized as non-monetary, yet it is critical to informing the Fed's effective monetary policy. Similarly, the Division of Financial Stability provides input into monetary policy decisions made by the bank's interest-rate-setting committee (the FOMC). Yet it too would likely be considered non-monetary under the proposal. This Congress and this committee have often inveighed against burdensome regulations and reporting requirements, yet this part of the proposal forces regulators to try to make burdensome, costly, and infeasible divisions between the bank's monetary and non-monetary functions.

CSBS SINCE 1902
CONFERENCE OF STATE BANK SUPERVISORS

January 10, 2018

The Honorable Andy Barr
Chairman, Subcommittee on Monetary Policy and Trade
House Committee on Financial Services
United States House of Representatives
Washington D.C. 20515

The Honorable Gwen Moore
Ranking Member, Subcommittee on Monetary Policy and Trade
House Committee on Financial Services
United State House of Representative
Washington D.C. 20515

Dear Chairman Barr and Ranking Member Moore:

On behalf of the Conference of State Bank Supervisors (CSBS),[1] I am writing to express state regulators' opposition to a provision in draft legislation pending before the House Financial Services Committee's Subcommittee on Monetary Policy and Trade. Section 1 of the draft legislation to bring the non-monetary policy related functions of the Board of Governors of the Federal Reserve System into the appropriations process[2] includes language that would impose a tax on state-chartered banks by requiring Federal Reserve to assess new fees on state-chartered banks to cover the cost of the Federal Reserve System's bank supervision activities.

State banking regulators charter and supervise approximately 4,570 institutions, representing over 78 percent of the nation's banks. This proposed bank tax has the prospect of affecting every one of these state-chartered institutions. These banks would pay more for the same level of supervision. This fee will hit the smallest, state-chartered community banks the hardest, and will divert money that could otherwise be put to work in their communities.

While we appreciate the broader objective of increasing agency oversight and accountability, it is important to highlight the downstream unintended consequences. Beyond its direct impact on individual institutions, this change in federal agency funding upsets the balance of the dual banking system. These bank exam fee proposals create regulatory uncertainty that undermines

[1] CSBS is the nationwide organization of banking regulators from all 50 states, American Samoa, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. For more than a century, CSBS has given state supervisors a national forum to coordinate supervision of their regulated entities and to develop regulatory policy.
[2] https://financialservices.house.gov/uploadedfiles/bills-115_fedapp365_pih.pdf

the regulatory choice that is fundamental to the dual banking system. Additionally, this proposal will have the effect of diminishing the role of locally accountable state regulators, forcing a bias toward centralized, inside the beltway federal bank supervision.

We appreciate the work that the House Financial Services Committee has done to advance proposals to right-size bank regulation and increase agency transparency and accountability. These goals can be accomplished without imposing a new tax on banks, and CSBS looks forward to working with you to ensure this outcome.

Yours truly,

John W. Ryan
President and CEO

cc:
The Honorable Jeb Hensarling, Chairman, House Financial Services Committee
The Honorable Maxine Waters, Ranking Member, House Financial Services Committee

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House Financial Services Committee

Subcommittee on Monetary Policy and Trade

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January 10, 2018

Dear Representative,

On behalf of the Center for Popular Democracy's Fed Up coalition, we write to comment on the Federal Reserve reform proposals before the Subcommittee on Monetary Policy and Trade today. The Fed Up coalition was formed out of a recognition that the Federal Reserve is one of the most important economic policymaking institutions in the country. As such, Fed Up believes that the Federal Reserve must become a fully public institution, accountable to the public, and representative and reflective of the interests of the whole economy, including working families and communities of color. Unfortunately, most of the legislative proposals being discussed at today's hearing take the Fed in the exact opposite direction.

The most misguided proposal seeks to make the presidents of all 12 regional Reserve Banks permanent voting members of the Federal Open Market Committee (FOMC). Regional Reserve Banks are private institutions, legally owned by the commercial banks that they oversee. Their presidents are private officials, accountable only to the Reserve Banks' boards of directors, two-thirds of whom are elected by commercial banks. Reserve Banks' boards have consistently failed to fulfill their statutory obligation to "represent the public," and directors are disproportionately white, male, and from corporate and financial backgrounds. As private officials at the head of private institutions, Reserve Bank presidents and the Banks they run are exempt from the Freedom of Information Act as well as from oversight by the Fed's Office of Inspector General.

In recent years, the process for selecting and re-appointing Reserve Bank presidents has been shown to be opaque, inbred, and *pro forma*. Directors tend to choose longtime Fed insiders and bankers who share their economic perspectives and background. In 2015, three consecutive individuals with strong ties to Goldman Sachs were chosen to lead the Reserve Banks of Philadelphia, Dallas, and Minneapolis. In Dallas and Philadelphia, the individuals chosen were involved in their own selection, and the selection processes violated the spirit of a Dodd-Frank Act reform intended to limit commercial bankers' influence on the selection process. Retiring Dallas Fed President Richard Fisher convened his own advisory committee to undertake the search for his successor. Philadelphia Fed President Patrick Harker was a banker-elected, Class B director at the Philadelphia Fed, and cleared the way for his selection by stepping down as chair of the search committee tasked with finding a new president.

Last year, the resignation of Richmond Federal Reserve President Jeffrey Lacker demonstrated the failure on the part of Reserve Bank boards to properly supervise their presidents, and highlighted the excessively cozy relationship between the financial sector and Reserve Banks. Lacker resigned after admitting to leaking market-sensitive information to the hedge fund advisor Medley Global. Federal officials investigating the leak had informed the board of the Richmond Federal Reserve that they were interested in speaking with Lacker about his role in the leak as early as May 2015, yet the Richmond

Fed's board enthusiastically and unanimously recommended Lacker's re-appointment to a five-year term at the end of 2015. As the Lacker incident demonstrates, Reserve Bank presidents are accountable only to oversight and *pro forma* re- appointment by their corporate boards. When the Richmond Fed board undertook the process for finding Lacker's replacement, numerous members of Congress weighed in to urge a transparent and publicly inclusive process, but these calls were largely ignored. After nearly a year of searching, the Richmond Fed completed their closed-door process by selecting yet another white man with a history of advising the financial sector.

All Reserve Bank presidents are FOMC participants with access to market-sensitive information and influence over important decisions affecting the economy. The FOMC was created with the intention of ensuring that the Federal Reserve Bank presidents—as heads of private institutions—would only constitute a minority of the voting members of the FOMC. By giving all 12 regional Reserve Bank presidents a permanent vote on the FOMC, the proposal would ensure that monetary policy is primarily set by private officials with no duty whatsoever to be accountable to the public. This proposal to further empower private officials with vital public policy decision-making authority is a contravention of democratic principles.

Another proposal being considered today seeks to restore the role of financial sector representatives (Class A directors) in choosing Reserve Bank presidents. This proposal would exacerbate the problems with the Reserve Bank presidential selection process discussed above. Congress wisely eliminated Class A directors from the selection process after the financial crisis, in large part because of the conflicts of interest posed by bank executives exerting power over one of their chief regulators.

The Government Accountability Office conducted a study of apparent conflicts of interests at the Reserve Banks following the financial crash, and found that 18 current and former directors at the Reserve Banks were affiliated with institutions that received a combined $4 trillion in emergency lending during the crisis. Most famously, JP Morgan Chase CEO Jamie Dimon sat on the New York Fed's board at the very moment that the Fed was extending billions of dollars in assistance to JP Morgan Chase. General Electric CEO Jeffrey Immelt also sat on the New York Fed's board while the New York Fed consulted with GE to provide billions in lending and establish the commercial paper funding facility. The appearance of impropriety would be re-established were Class A directors to have their power in choosing Reserve Bank presidents restored. If this proposal were enacted today, current New York Fed director James Gorman, the CEO of Morgan Stanley (which received $108 billion in bailout money) would have a role in choosing the next New York Fed president.

We are also concerned about the proposal to subject the Fed's regulatory operations to the congressional appropriations process. Currently, the Fed generates its own budget through open market operations, and uses a portion of that budget to supervise commercial banks. A number of financial regulatory agencies, like the FDIC, are able to conduct effective oversight of the financial sector because they rely on funding generated from the financial sector itself. Because prudent financial regulations are so important to the protecting the public, it is crucial that these agencies are independent from the political influence exerted by the industry that they oversee. Financial regulatory agencies that do not enjoy this independence, such as the SEC, have seen their regulatory powers hindered by budget constraints and political considerations. If Congress wants more oversight over and insight into the Fed's operations, it can end the commercial banks' ownership of the regional Reserve Banks, thereby ending

the exemption to FOIA those banks currently enjoy, and ensuring that a larger share of the Fed's profits are submitted to the Treasury rather than through a dividend to commercial banks.

There are many steps that can and should be taken to ensure that the Federal Reserve represents the public interest, rather than advancing the interests of the financial industry. The Fed Up campaign has detailed these steps in numerous reports, including our proposal to make the Fed a fully public institution. We urge the Subcommittee to reject the proposals it is considering today, and turn instead to proposals that truly increase the public accountability and representativeness of the Fed.

Thank you for your consideration. For more information, please contact Fed Up's Campaign Manager Jordan Haedtler at jhaedtler@populardemocracy.org.

Sincerely,
The Center for Popular Democracy's Fed Up coalition