Testimony before the House Financial Services Committee

Subcommittee on Monetary Policy and Trade

Hearing entitled "What Is Central About Central Banking?:

A Study of International Models"

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Chairman Campbell, Ranking Member Clay, and Members of the Committee, thank you for the opportunity to testify in this hearing. It is a privilege for me to contribute to your discussions of what is central to central banking, when you rightly take stock of the Federal Reserve's performance and governance after 100 years of operation, and after five years of its policy responses to the North Atlantic financial crisis centered here in the US. As someone who has been studying differences in central banks' structures and performance for twenty years, and has worked in a number of the major central banks as an economist, consultant, and policymaker, I commend your taking a comparative international approach to benchmarking the Fed's performance and role.

I would like to address two sets of issues regarding the operational structure of central banks in my testimony. All of these have a significant influence on the ability of central banks operating in democracies with market economies to fulfill their public mission. All of these show some significant

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variation among the major central banks in critical aspects of their capabilities and practices. And some of these represent areas where the Federal Reserve System, and the relationship between the Fed and Congressional oversight, could benefit from improvement.

- Governance of the central bank and setting of its policy goals
- Tools available to the central bank for policy implementation

As my colleagues, Messrs. Lachman, Makin, and Orphanides, have argued in their written testimony submitted for this hearing, and as your Committee staff has documented, the major central banks in democratic countries hit by the financial crisis – the Fed, European Central Bank [ECB], Bank of England [BoE], Bank of Japan [BoJ], Swiss National Bank [SNB], and others – have responded along largely the same lines: cutting instrument interest rates to near zero, expanding their balance sheets by buying securities, aggressively intervening to counteract market disruptions during the height of the crisis, and maintaining an easy stance of monetary policy (to varying degrees) through the present.

The economies and publics they serve have seen largely the same results on the broad macroeconomic aggregates: very low inflation with little inflationary pressure, some improvement in growth and employment but far from total recovery, little market pressure on longer-term government debt securities, and relatively stable currencies after some discrete one-time adjustments. I believe this is the result of these central banks getting policy more or less right, but being insufficiently aggressive about stimulus in some cases, and being outweighed by fiscal and banking developments overall.

Still, below the top line similarities of policy and performance from mid-2008 to present, there are some important differences between the Fed and its peer central banks in outcomes. More importantly, I would argue, there are divergences and vulnerabilities between central bank practices that are becoming highly salient as we get further from the overt crisis and turn to the

more contentious issues of when and how to tighten monetary policy, providing financial stability, and handling the feedback from the policies already pursued upon our own and other economies.

Chairman Bernanke and the FOMC are to be praised for their crisis response which saved the American people from terrible economic outcomes, what would have been far worse than what we actually suffered - good leadership and management in a crisis is never a foregone conclusion. But in a sense, during a financial crisis the right direction for monetary policy is clear, and the central bank's choice of tools is simply to use everything you got fast. The FOMC and the members of this Committee should now be thinking ahead about how to prepare our central bank for future policy challenges when there will be more room for genuine debate about the right direction of policy and the right methods with which to pursue that policy goal.

1. Governance of central bank goal setting –

Accountability is a two-way street. The Federal Reserve must be overseen by elected officials, as it currently is, and as all central banks should be. But the form and nature of that oversight must allow for the central bank to make policy without undue political pressure or arbitrary interference. The best practice for making such oversight work is to distinguish between goal and instrument independence for central banks – central banks should have instrument independence, but not goal independence.[2]

That is, the elected officials set the goal of policy, usually called the central bank's mandate, and the technocratic leaders and staff of the central bank are left to pursue those goals by the means and measures they think best. Of course, the central bankers – in the US, the FOMC members – have to be held accountable for their performance in meeting those objectives, but that

[2] As defined by Stanley Fischer in 1994. See: Debelle, Guy and Stanley Fischer. 1994. How Independent Should a Central Bank Be? In J.C. Fuhrer (ed.), *Goals, Guidelines and Constraints Facing Monetary Policymakers*. Federal Reserve Bank of Boston, 195–221.

should be done retrospectively, based on a few years' policies and outcomes at a time. Monetary policy decisions cannot be fully evaluated in real time, given the lags between when policy is set and the full effects are seen. That is part of what makes it so challenging for both central banks and elected legislators.

Perhaps this sounds self-evident. But international experience shows that this distinction matters greatly. Where central banks have too much goal independence, bad things happen. In Japan, throughout the 1990s and most of the 2000s, the BoJ Policy Board was allowed to define price stability as it saw fit, and allowed the economy to enter an extended period of deflation. Worse, the BoJ eluded accountability for its policy failures for much of the period, and publicly blamed deflation and terrible economic outcomes on everything but monetary policy without sustained political challenge. In the euro area, the ECB has to some degree run amok, ignoring its mandate to achieve price stability of near 2% inflation, ignoring its obligation to pay attention to broad credit growth, and ignoring wide divergences in monetary outcomes across the whole of the European Monetary Union. Instead, it has entered into the budget politics of sovereign member states and even their regulations of non-financial sectors like labor markets and tax policy.

As I warned in 1993, when the ECB structure was first proposed, having an unaccountable central bank with no parliament above it, its independence protected by essentially inviolable international treaty, was a recipe for excessively and destructive counter-inflationary extremism.[3] This is indeed what has happened in response to the crisis, though the ECB has moderated somewhat in the last 18 months. In contrast, in the United Kingdom and Switzerland, where the BoE and SNB are very much goal dependent and answerable to elected officials, there were salutary corrections to the

[3] See Adam S. Posen, "Why Central Bank Independence Does Not Cause Low Inflation: There is no institutional fix for politics," in Richard O'Brien, ed., *Finance and the International Economy: 7*, Oxford University Press, 1993.

operational goal of monetary policy in response to crisis developments, to allow for specified areas of flexibility and minimum standards in other areas – more response to real volatility and to slow growth for the BoE, more concern with the exchange rate in opposition to deflation for the SNB.[4] Earlier this year, the new Japanese government did finally hold the BoJ accountable for its failure to deliver on a reasonable operation definition of price stability, meaning its insufficient effort and responsibility to fight deflation. The BoJ has changed policies to meet its clearly and legitimately set goal, and has delivered good results.

Do the Congress and the Fed have it right on goal dependence versus instrument dependence? Certainly more so than the ECB, but the relationship is not perfect. As we have recently established in some new research, having elected officials set and reset central bank goals in a transparent manner has minimal effect on inflation outcomes, and even on the anchoring of inflation expectations (i.e., how much inflation drifts upwards when there is a cost shock or a monetary accommodation).[5] Central bank independence is not fragile to even robust oversight of goals.

Yet, there is much hubbub in the Congress and among some commentators when the Fed adjusts its targets in response to the crisis in a transparent way and in consultation with Congressional oversight that independence is being compromised. This is wrong. So, too, however, is the reluctance of Fed officials to let Congress discuss directly the definition of goals, engendered by the justified fear that any re-opening of the Federal Reserve Act could be a Pandora's Box. We need a process by which the Fed's

[4] See my testimony to the Joint Economic Committee on April 18, 2013, http://www.piie.com/publications/testimony/posen20130418.pdf, and the recent speech by the SNB Chairman Thomas Jordan on October 8, 2013, http://www.piie.com/publications/papers/jordan20131008ppt.pdf.

[5] See Kenneth Kuttner and Adam Posen, "Goal Independence for Central Banks: Is the malign view correct?", November 7, 2013, http://www.imf.org/external/np/res/seminars/2013/arc/pdf/posen.pdf

operationalization of its current Dual Mandate can be reviewed and debated by Congress without the threat of massive institutional change or politicization. This was one of the reasons why the current Fed Chairman with co-authors (including myself) advocated an inflation targeting framework for US monetary policy explicitly in a framework of Congress setting the inflation target.[6] There are other options, but we need a decent process for so re-setting.

The real issue, however, is the extreme distrust which many members of Congress are showing towards the instrument independence of the Fed. The extreme form is the absurd conspiracy theory that seems to be behind the idea of "auditing" the Fed, that somehow there are purchases and sales of Fed assets that have taken place without public knowledge or oversight. This is demonstrably false. The Fed's balance sheet and market operations are more transparent than their or any other central banks' have ever been (some issues over disclosure of specific bank names in crisis bailouts aside). But there are three far more operationally significant areas where excessive Congressional distrust harmfully interferes with instrument independence:

- Minutes – No other central bank is required to produce literal transcript minutes of such detail at such frequency as Congress requires of the FOMC. This has a chilling effect on the willingness of FOMC members to speak on the record, openly debate policies, and to advance ideas and positions that may later be proven wrong (even if useful to discussion). This distorts internal and side meetings of FOMC members as well, and conveys no useful information except for 'a-ha gotcha' purposes beyond what more edited depersonalized minutes as the BoE, ECB, and others produce. This also makes FOMC members less accountable for their individual votes and opinions. Congress should revised this requirement.

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[6] Bernanke, Ben, et al, *Inflation Targeting: Lessons from the International Experience*, Princeton University Press, 1999.

- Capital – On paper, all central banks have an amount of capital on their balance sheets that is at the basis of their operations. In financial and economic terms, this is a meaningless line-item not a real constraint – the central bank can always print money and engage in operations, and so long as the elected officials have the central bank's back, the capital can be replenished if temporarily eroded for some reason. But politically, this becomes a huge source of threat to hold over monetary policymaking if it can be used to express dissatisfaction with what means a central bank is using to pursue its mandated goals. This has led to bad self-censoring in the ECB case. In Japan, the BoJ used this as an excuse for inaction. Here in the US, arguably the FOMC is making decisions about how to handle the assets on its balance sheet with an eye as to avoid attracting Congressional opprobrium rather than pursuing the best use of the assets as tools. I would argue that the Fed should be thinking about selling off bonds when it is time to tighten policy, but many would have the Fed hold on to them to maturity simply to avoid registering a paper loss Congress might use as a club. Congress should give the Fed in advance an indemnity against losses on its balance sheet incurring in its monetary operations so long as they are in pursuit of mandated goals (which they would be), as the BoE has from HM Treasury.[7]

- Specific constraints on Fed purchases – While setting goals and evaluating the competence of pursuit of those goals is rightly Congress' role with respect to the Fed, judging what are the appropriate means to achieve those goals a priori is not. The Congress, despite its best efforts and strong staff, is not qualified to make that technical evaluation of what the Fed can buy and sell; no one, even experts, can really make

[7] See my discussion of this issue in a speech from my time on the BoE Monetary Policy Committee, June 11, 2012: http://www.telegraph.co.uk/finance/economics/9324650/Adam-Posens-speech-in-full.html

that evaluation except ex post, and as a judgment dependent upon the economic context in which the purchases and sales are made; and it is inherently a politicization of monetary policy decisions that would be harmful to price stability to have elected officials getting involved in granting and withholding operational options to the Fed. No other major central bank – not the ECB, BoE, BoJ, SNB, or any others - in a democracy has the kind of constraints on its balance sheet operations that Congress has increasingly imposed on the Fed. Had these constraints been in place during 2008-09, we would have had a disaster when other central banks flexibly and aggressively responded to financial crisis. In fact, the ECB actually led the way in so doing and was initially ahead of the Fed in crisis response because of reluctance on the Fed's part due to worries about attracting congressional interference. The Congress should respect the Fed's instrument independence, and only evaluate what tools or assets the Fed uses retrospectively as part of the overall competence accountability.

2. Tools for the pursuit of financial and price stability –

Since the Congress is at present deeply involved in setting limits on the Fed's tools in pursuit of its mandated goals, and since the long-term structure and performance of the Fed is certainly within Congress' legitimate purview, let me now address the issue of what tools the Fed does or does not have in comparison with other central banks. The place to start is with the operational – as opposed to the independence – aspects of the current limits on Federal Reserve asset purchases. These are truly exceptional, and are likely to be extremely harmful to the pursuit of financial stability by the Fed.

Public debate has also been allowed for too long to stigmatize "unconventional" monetary policy, and wax nostalgic for the days of a simpler Fed mission. The Fed has, perhaps understandably, let this happen for fear of provoking further political interference. But such defensiveness and self-

limitation is based on a mischaracterization of the past and creates a dangerous vulnerability for the US economy. For literally centuries, central banks have bought and sold private sector assets as a necessary part of their operations. There was a brief interlude, from the late 1970s through the mid 2000s when it looked like the Fed and other rich country central banks could implement monetary policy and maintain financial stability solely by purchases and sales of the short-end of the government bond market. To a large and increasingly evident degree, the extent to which this reliably worked versus the was always overestimated, was based on a theoretical fiction about how interest rates affected the real economy, and was simply politically convenient because it pretended Fed policies did not have an impact on income and wealth distribution.[8]

Congress will have to make it possible for the FOMC to treat so-called unconventional monetary policy as conventional, and establish a viable oversight framework for doing so. The great lesson of the global financial crisis for monetary policy is that there is no one interest rate that determines or even represents credit conditions in the modern economy. Recent events show the more complex reality of how monetary policy is transmitted to the whole economy, as opposed to just bond markets. In the euro area, low interest rates and commitments to government bond market intervention are failing to improve credit conditions for small and medium-sized businesses across southern Europe. The BoJ has only been able to successfully reverse deflation by changing the mix of assets it purchases to longer-maturity and some private assets; when it solely bought short-duration JGBs, its quantitative easing was ineffective.[9] In China, Hong Kong, and Turkey, attempts to constrain property lending booms have required targeted measures as well as rate rises. Right

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[8] See my discussion of the distributional issues of monetary policy in Adam Posen, "After Bernanke, Make Unconventional Policy the Norm," Financial Times, July 15, 2013. http://www.piie.com/publications/opeds/oped.cfm?ResearchID=2442

[9] See my discussion of Japanese monetary policy pre-2013 in Adam Posen, "The Realities and Relevance of Japan's Great Recession: Neither *Ran* nor *Rashomon*," June 2010, http://www.piie.com/publications/interstitial.cfm?ResearchID=1592

now, the BoE is allowing the blowing of another housing price bubble by not intervening directly to offset mistaken government policies.

In the United States, the Fed's purchases of mortgage-backed securities have done more to promote the current private housing-led economic recovery than buying long-dated Treasuries alone could ever have done. It is sheer luck that purchases of mortgage-backed securities were still allowed by Congress and that happened to be the right thing to buy to deal with the US mortgage-centered debt crisis. If the next crisis comes in American money market mutual funds or local banks' capital, the US economy may not be so fortunate because the Fed will not be able to intervene effectively.

To repeat, no other major central bank is constrained in this way that Congress has constrained the Federal Reserve – if anything, the right lesson of the crisis is that central banks have to be ready to intervene across a wide range of asset markets and deal with multiple credit markets. That is why all other major central banks have at least as much flexibility with regard to tools as before the crisis, if not having been granted additional capabilities. Congress has taken the Fed in exactly the wrong direction.

Worries about losses on risky assets are nothing but a distraction. The purpose of Fed market operations is to deal with major macroeconomic shocks and trends that have huge impact on the economic well-being of all Americans. Whether the Fed temporarily loses money on a small part of its portfolio or temporarily distorts a hypothetical pure market outcome for a particular asset class in service of that greater good should not be a constraint on doing the right thing. Yet, some in Congress are fixated on these potential paper losses and that fixation translates into both legislative interference and the FOMC pre-emptively ruling out policy options and instrument it should actively consider solely for political fears. And of course, the cumulative gains that the Fed has transferred to the US Treasury over the decades outweigh by two

orders of magnitude any potential losses on the Fed's balance sheet in a given set of operations. And we would not want the Fed to have justified let alone pursued the QE policies it did just for the sake of showing a profit!

My final point is to warn the members of this Subcommittee of letting further counter-productive constraints on the Fed's range of policy options creep in through a particular back door. As this is the Monetary Policy and Trade Subcommittee, you are no doubt aware of some initiatives to make strictures against currency manipulation requirements for some trade pacts such as TPP currently under negotiation by the US, or as a pre-requisite for granting Trade Promotion Authority to the Administration to negotiate those pacts. I will leave aside that debate in general terms today. I will, however, say that it would be the ultimate usurpation of the Fed's necessary instrument independence, and even more so of Congress' legitimate oversight of the goals for US monetary policy, were such a trade condition to be used against the Fed's own choice of instruments.

Yet, that is a concrete and significant danger if such trade requirements were to be poorly or too broadly drafted in the legislation. Countries would unfairly and harmfully insist that Federal Reserve monetary policy – necessary to the well-being of the US economy – would have to be limited or even reversed if it could be construed as 'currency manipulation.' They would be pursuing their own mercantilist self-interest at huge macroeconomic cost to the US economy. Thus, any such legislative language much be clearly linked to explicit acts of currency manipulation, involving the one-sided sustained intervention by purchasing with official reserves by countries already in substantial trade surplus. It must not be allowed to treat expansionary monetary policy directed at domestic goals to be constrained from the outside.

Thank you for your attention.