Statement of William E. Spriggs

"Diversity and Balance in Federal Reserve Leadership"

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Thank you to Chair Bill Huizenga and Ranking Member Gwen Moore for this invitation to give testimony before your subcommittee today on issues of governance, monetary policy and economic performance with respect to the regional banks of the Federal Reserve.

There has been much questioning of the conduct of monetary policy since the onset of the Great Recession and the financial sector collapse of 2007-2008. Economists continue to learn a lot about the causes of the collapse. Clearly, the role of exploitative mortgage instruments, and not the character of the borrowers, in the sub-prime market are a culprit.[1] President Obama responded to the need evinced by this to protect consumers, and the financial industry, by creating the Consumer Finance Protection Board in the Dodd-Frank Wall Street Reform and Consumer Protection Act legislation passed by Congress in July 2010. And, it reflects a sense that the financial regulatory agencies failed because they did not give consumer protection sufficient attention.

Economists have tried to understand what the Federal Reserve was thinking before the crisis, taking advantage of the transcripts of the meetings of the Federal Open Market Committee (FOMC), the monetary policy arm of the Federal Reserve Bank. Focus has been on the Fed's

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[1] Laurie Goodman and Wei Li, "New credit availability measure shows product risk, not borrower risk, fueled the housing crisis," Urban Institute, 9 December 2014 http://www.urban.org/urban-wire/new-credit-availability-measure-shows-product-risk-not-borrower-risk-fueled-housing-crisis

recognition of the potential of the risks from a housing bubble.[2] Though equally disturbing was inattention to the potential harm to consumers. And, there has been focus on governance structure and concerns of regulatory capture, perhaps as benign as the use of common models producing "group think."[3]

In my testimony, I will focus on the governance structure as it relates to economic performance measures. Let me first say that currently the Federal Reserve's policies have been key in pulling the economy out of the worse downturn since the Great Depression, and a strong reason the United States is outperforming the rest of the advanced economies recovering from the Great Recession. But, the current structure does not guarantee this outcome. Sustaining the recovery without the typical accompaniment of fiscal policy is unchartered. So far, Chair Janet Yellen's leadership has navigated this very well.

When the Federal Reserve system was created, interstate banking laws limited the reach of New York and Wall Street. Banks in the region still sometimes competed with state chartered banks. In Illinois, and some other states, there were even limits on branch banking. This tied the fortunes of banks in the various regions to the economies of their region. So, it might be argued that they could be sensitive to monetary policy that had different impacts on the industries in their region than on Wall Street banks. Today's banking industry is very different. The level of concentration and the strength of a few national banks is much greater than in 1913. There is some evidence that Federal Reserve Regional Bank Presidents, are nonetheless, influenced by the unique unemployment rate experienced in their regions when they are members of the FOMC.[4]

There is a clear sense that the current governance structure, giving ownership of the regional banks to the banks within their jurisdiction reflects certain notions of interest capture. Most notably, regional bank presidents greatly reflect the gender and racial makeup of executives in

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[2] Stephen Golub, Ayse Kaya and Michael Reay, "What were they thinking? The Federal Reserve in the run-up to the 2008 financial crisis," *Review of International Political Economy*, 22, Issue 4 (2015): 657-692.

[3] Lawrence G. Baxter, " 'Capture' in Financial Regulation: Can We Channel it Toward the Common Good?," Cornell Journal of Law and Public Policy, 21 (2011): 175-200.

[4] Ellen Meade and D. Nathan Sheets, "Regional Influences on FOMC Voting Patterns," *Journal of Money, Credit and Banking,* 37, No. 4 (2005): 661-677 while a different view is shown in Alexander Jung and Sophia Latsos, "Do Federal Reserve Bank Presidents Have a Regional Bias," European Central Bank, Working Paper Series, No. 1731 (September, 2014) https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1731.pdf?6d19a02639b7e87fbb67ba31b62f91e5

the banking industry. In its history, no regional bank president has been either a Latino or an African American. A recent review of the board members for the regional banks, who in turn recruit and nominate the regional bank presidents, showed that 83 percent were white and almost 75 percent were male. Again, a mirror of the executives in the banking industry. Only three of the board members represent labor organizations.[5]

At least one reserve bank president felt the absence of diversity when reflecting that the severity of the downturn's effect on unemployment in the African American community did not get mentioned in the 2010 FOMC transcripts; a year when the African American unemployment rate never fell below 15.2%.[6] An odd oversight given the way in which subprime mortgage lenders targeted the African American community, and hence the collapse of home values, consumption and local government revenues would be correlated; giving insight where signs of deepening problems or signs of recovery might appear.

The other potential capture is that regional bank presidents and members of the Federal Reserve Board of Governors are overwhelmingly either academic economists or worked for Goldman Sachs. Economists in the academy are among the least racially or gender diverse of social scientists.[7] And, only a small handful of schools produce the economists leading the Fed.[8] This can allow for people who look like and communicate in a common language with the banking community. It does not mean capture, in thinking the same thing, but capture in agreeing on models, evidence and frameworks.

However, the process can, on occasion, produce regional bank presidents who are very responsive to meeting with the public. President Esther George, for instance, reaches out to meet with a diverse set of constituents including those most effected by high rates of unemployment. She has also opened up her annual research symposium to allow direct dialogue with those

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[5] Connie Raza, " 'To Represent the Public': The Federal Reserve's Continued Failure to Represent the American People," The Center for Popular Democracy (February 2016) https://populardemocracy.org/sites/default/files/Fed%20Up.pdf

[6] Narayana Kocherlakota, "MLK Day Reflections on the FOMC" https://sites.google.com/site/kocherlakota009/home/policy/thoughts-on-policy/1-18-16

[7] Amanda Bayer and Cecilia Rouse, "Diversity in the Economics Profession: A New Attack on an Old Problem," Princeton University Industrial Relations Section, Working Paper #597 (July 2016 fe http://dataspace.princeton.edu/jspui/handle/88435/dsp01bc386m66h and Gregory Price, "The Problem of the 21st Century: Economics Faculty and the color line," *The Journal of Socio-Economics,* 38, No. 2 (2009): 331-343.

[8] Mark Calabria, "Yes, The Federal Reserve has a Diversity Problem," June 23, 2016 http://www.alt-m.org/2016/06/23/yes-the-federal-reserve-has-a-diversity-problem/

communities who have not fully recovered. Similarly, some of her fellow presidents, like President Jeff Lacker have followed suit to go outside the walls of the bank to meet directly with labor leaders in their region. But, regrettably, while some regional bank presidents have followed this lead, others have not. And, so while the system can produce presidents who seek dialogue with the public, it must be said that this level of outreach is new and it is not guaranteed. So, it is still too possible for regional presidents to be insular; moving in a closed circle.

Economists believe that the pre-amble to the Humphrey-Hawkins Full Employment Act, which reads:

> "To translate into practical reality the right of all Americans who are able, willing, and seeking to work to full opportunity for useful paid employment at fair rates of compensation; to assert the responsibility of the Federal Government to use all practicable programs and policies to promote full employment, production, and real income, balanced growth, adequate productivity growth, proper attention to national priorities, and reasonable price stability;"

is a dual mandate that means the Federal Reserve should equally pursue full employment and maintain price stability. That is not what Congressman Hawkins believes was the intent. When he proposed the Act in 1977, the African American unemployment rate averaged 14.0% and reducing that was his focus.

A few years later, Paul Volcker as chair of the Federal Reserve Board of Governors took the maintenance of price stability as a mandate to engineer a massive and deliberate recession to lower inflationary expectations; unemployment spiked to levels not seen since the Great Depression, and for the entire 1980s, the African American unemployment rate would not fall below 11.0%. Economists call the subsequent period after economic recovery began in 1984 as the Great Moderation. It corresponds to a period that would be advantageous to Wall Street and reinforce the theories of some economists on the role of monetary policy.

Since 1984, inflation has averaged 2.7%[9], and the variance in price movements was greatly reduced compared to before 1978. From 1948 to 1978, inflation averaged 3.6%, but with much wilder fluctuations.

In practical terms, from 1948 to 1978, when the Fed and fiscal policy makers were more sensitive to unemployment, the average monthly unemployment rate was 5.1%. During the Great Moderation it has averaged 6.1%. To understand the difference, since 1984, American workers have only spent 25% of the time with the monthly unemployment rate below the 5.1% average level of the pre-1978 era; this is despite a significant increase in educational attainment by all Americans, and a huge decrease in the variation in educational attainment.

It would be more accurate to say that the Fed pursues price stability, and tries to maximize employment consistent with that goal. That is not the same thing as pursuing full employment as the right of all Americans while maintaining reasonable price stability.

The Fed has one main policy tool, the ability to push short term interest rates up, or down. But, one tool with two policy objectives means the two goals must be weighted, since they potentially conflict. In 2007 and 2008, when the Fed was faced with a potentially destabilizing housing bubble, a third legislated mandate, the prudent management of the financial sector, added a third and very conflicting additional policy objective.

Getting the unemployment rate below 5.0% is critical to producing a labor market where workers can sustain wage gains, and labor market dynamics can let more productive workers quit lower paying jobs and move to more productive employment. This was one of the elements that helped hourly compensation for workers to increase along with productivity before 1974. For labor economists, that is a marker of the allocative efficiency of free labor market, and so is an indicator of full employment. However, since that period, a wedge has grown between compensation and productivity. And, the healthy churning of the labor market, with workers shifting to higher productive firms has been diminishing.[10]

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[9] Monthly CPI seasonally adjusted percent change from previous 12 months. The standard deviation was 3.12 from 1948 to 1978, and from January 1984 to August 2016 it is 1.35.

[10] Steven Davis and John Haltiwanger, "Labor Market Fluidity and Economic Performance," National Bureau of Economic Research, NBER Working Paper No. 20479 (September 2014) http://www.nber.org/papers/w20479

Because of overt labor market discrimination prior to the passage of the Civil Rights Act in 1964, the forces of competition from full employment were greatly limited in lowering discrimination in the labor market. But, research has found that particularly for young workers who benefited from lower discriminatory barriers, between 1964 and 1980, there was convergence in labor market experiences for young African American and white men. The convergence was most marked for college graduates, where wage gaps were almost non-existent. But, beginning in the 1980s, and the prolonged period of extreme unemployment rates for African Americans in an economy with high unemployment, gaps in labor market outcomes grew; most noticeably for college educated workers who had such small gaps at the beginning of the decade.[11] When unemployment was allowed to fall near 4% in the late 1990s, research showed this helped start a reversal and gaps between young African American and white men started to shrink.[12]

Currently, the unemployment experience for better-educated African Americans is worse than the unemployment rates for less educated whites. This is true, even when controlling for cognitive test score differences.[13] But, as the labor market tightens, there are fewer unemployed compared to the number of job openings, and those unemployment disparities grow smaller. And in fact, the work of competitive forces to lower discrimination is an explicit finding in the Humphrey-Hawkins Full Employment Act (Section 2 (b)(4)).

So, at full employment we would expect strong wage growth and lower levels of discrimination, consistent again with what labor economists would believe to be the allocative efficiencies of a free labor market. But, this definition of full employment, and the one of every able-bodied person finding a job at decent pay as described in the Humphrey-Hawkins Act are not the operating definition used by the Fed.

Again, with few tools but many goals, giving the proper weight to price stability and to unemployment means that policy makers must assign weights to the value of each goal.

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[11] John Bound and Richard Freeman, "What Went Wrong? The Erosion of Relative Earnings and EmploymeTatnt Among Young Black Men in the 1980s," *The Quarterly Journal of Economics*, 107, No. 1 (1992): 201-232

[12] Richard Freeman and William Rodgers, III, "Area Economic Conditions and the Labor Market Outcomes of Young Men in the 1990s Expansion," National Bureau of Economic Research, NBER Working Paper No. 7073 (April 1999) http://www.nber.org/papers/w7073

[13] Donna Rothstein, "An analysis of long-term unemployment," *Monthly Labor Review*, July 2016

That is why diversity in who serves on the FOMC is so important. Regional diversity is not sufficient to represent the different interests of the public in how the economy functions. Many institutional factors and history intervene such that the economy does not impact everyone the same. And, having different voices at the table is key in making policies that generally benefit the public.

So far, the Fed's structure has failed to provide that diversity. If the Fed had noticed in the latter half of 2007 that Latino and African American unemployment rates were rising, it might have understood a significant problem was on the horizon. Because the mortgage industry had targeted those communities with pernicious loan instruments with massive pre-payment penalties, then the rise in unemployment would have been a warning that a large round of foreclosures was about to take place.

A similar challenge is present today. If the Latino or African American unemployment rates start to rise, the current pattern of sub-prime auto loans that have been targeted at those communities could mean that a rash of auto repossessions will occur, dumping a large number of automobiles on a market where auto sales have peaked. While that is unlikely to bring on the financial collapse of 2007, it could lead to a downturn in one of the shining sectors of this recovery.

As long as banks are owners of the regional bank system, and have an inordinate vote in selecting the board, it is hard to see how the regional bank system is likely to provide the diversity in leadership needed to have a wide range of interests at the table when the FOMC meets. And, again, this is not just bad for one community. The failure of the Fed in understanding the coming crisis of 2007 hurt the entire economy. Even regional bank presidents from areas where the sub-prime foreclosure crisis was most severe failed to see the sub-prime market problem as an issue—not to the complex financial relationships that ruined the economy, but to the real economy phenomena that has devastated the finances of local governments and wiped out the wealth holdings of a generation of African American households.

In fairness, the Fed was not alone. The global financial system collapsed. And, in other countries central bankers are selected and governed differently; some with a single mandate of price stability, others with no presence of banking industry on their boards. Generally, it is agreed, the central bank of the United States did a far superior job of reacting to the crisis than did the European Central Bank or many other industrialized nations' systems. And, it is generally agreed that the sizable fiscal stimulus under President Obama in 2009 led to the current strength of the United States compared to the slower growth of the rest of the advanced economies.

The current consensus among economists, is that there is still a need for fiscal stimulus in the advanced economies. The International Monetary Fund, in making its recommendations for a healthier American economy, lists the need for increased investment in public infrastructure.[14] Similarly, the Organization for Economic Cooperation and Development has noted that the advanced economies are stuck in a low growth equilibrium because of a failure to use low interest rates and current fiscal space to push their economies out of this trap. Failing to make the investments, in fact, will lead to higher debt-to-GDP ratios, because GDP growth is being retarded by austerity policies.[15] Economists, from Nobel Laureates Christopher Sims, who addressed the Kansas City Federal Reserve Banks research symposium this past August, to Paul Krugman and Joseph Stiglitz all concur that what is needed at this point is a debt-financed fiscal policy to restore inflation to its target level and get employment levels to a normal level.

In fact, the fiscal response to this downturn is unique. In the 1980s and again at the start of this century, under President Reagan and President George W. Bush, Congress passed significant fiscal expansion that greatly increased the deficit to help push the economy out of recession. In doing that, Congress and the President were holding up their end of the requirements of the Humphrey-Hawkins Full Employment Act. The Act has clear requirements for fiscal authorities to report on what specific steps they plan to ensure full employment.

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[14] International Monetary Fund, *2016 Article IV Consultation with the United States of America: Concluding Statement of the IMF Mission* (June 22, 2016) https://www.imf.org/en/News/Articles/2015/09/28/04/52/mcs062216

[15] Catherine Mann, "Policymakers: Act now to break out of the low-growth trap and deliver on our promises," (June 1, 2016) https://oecdecoscope.wordpress.com/2016/06/01/policymakers-act-now-to-break-out-of-the-low-growth-trap-and-deliver-on-our-promises/

So, though the Congress and President are elected by the public, there is no assurance that policies trying to achieve full employment will hold. But, public participation does allow for a diverse set of voices in the process. And, so while Congress has failed to pass a fiscal stimulus since 2009, it is clear that some members of Congress and that the President in his budget has pushed many times to provide the same type of fiscal response seen in 1981 and 2001.

But, going forward, with the Fed, it is not guaranteed that many voices will be at the table. And, as the world grows more complex, the outcome of short term interest rate movements can have many consequences. Other central banks with responsibilities for balance of payments and currency react to the Fed policy choices that may affect the value of the dollar, or the demand for commodities or the price of corn. And, those central bank actions can affect the real wages of workers in their country, and the relative wages of Americans to those workers. Will all the voices of the public who may be effected by Fed policy get their say? And, would a broader set of interests and viewpoints enrich the Fed decision making process to avert harm in the real economy?

I believe that a narrow focus on price stability, with the intent of keeping inflation within a narrow range, has its value, but needs to be considered with a host of other factors which can have varying risks associated with them. A bank-controlled system is unlikely to look at the world from a borrower's perspective enough to properly assess those risks. I also believe that it is not possible to assess the role of the Fed in economic policy in isolation, since the Humphrey-Hawkins Act, and economists would generally agree, that the role of fiscal authorities is as important.

I think there is room for serious discussion of whether the current structure of bank ownership of the regional banks gets in the way of the FOMC having the necessary diversity to make well informed decisions that can weigh all the various interests in the American economy. While the current leadership of the Fed under Chair Janet Yellen is amenable to increasing that diversity, I think her efforts could be aided by a change in structure; and the American public would benefit in the future if diversity was assured by the structural design.