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CONGRESSIONAL TESTIMONY

Monetary Policy Reforms for 2018

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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.

[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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