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Federal Reserve Should Remain Free From Burdensome Constraints

Testimony of Jared Bernstein, Senior Fellow, Before the House Committee on Financial Services: Subcommittee on Monetary Policy and Trade

Chairman Barr, ranking member Moore and members of the committee, thank you for holding this hearing on the transparency, bond purchases, and lending policy of the Federal Reserve in periods of economic stress. As was the case when I testified before this committee a few months ago, I return with a similar message: the independence of the central bank is an essential ingredient to its timely, efficient, and effective functioning.[1] Of course, that independence exists within the legal context set forth by Congress, and, especially as the economy and markets evolve, it is not only appropriate, but essential, for this committee to continuously revisit this context. But in doing so, maintaining the central bank's independence and efficient functionality must always be an elevated consideration.

The bills under discussion today seek to alter the context within which the Fed operates by constraining some aspect of its operations, specifically emergency lending and bond purchases, and by adding reporting/transparency requirements. I find some of the ideas to be worthy of consideration, but some are too restrictive, threaten the Fed's independence, and add unnecessary and potentially damaging process requirements that could potentially do more harm than good to the U.S. and even the global economy.

Economic policy always invokes tradeoffs, in this case between the central bank's independence and ability to act quickly in emergencies on the one side, and its accountability and contributions to potential moral hazards on the other. Getting the balance right is more art than science, but a good place to start weighing the tradeoffs is to briefly consider recent Fed performance.

[1] "The Critical Importance of an Independent Central Bank," Testimony by Jared Bernstein, Senior Fellow, Center on Budget and Policy Priorities, Before the House Committee on Financial Services: Subcommittee on Monetary Policy and Trade, July 20, 2017, https://www.cbpp.org/economy/the-critical-importance-of-an-independent-central-bank.

What Is Congress Trying to Fix With These Proposals?

The American political system exists in a difficult moment. The word "dysfunction" is often heard in descriptions of our current situation and I suspect members of this committee would at least partially agree with that characterization. Members would also agree that partisanship is at a very high level and creates a tall barrier to working together to enact the nation's business.

Amidst these challenging times, the Federal Reserve is one institution that has been highly effective in carrying out its mission. Though the Fed failed to identify the housing bubble or forecast the crisis when the bubble burst, it quickly moved into emergency mode. The bank deployed its significant weaponry against the downturn, including its first line of defense — reductions of the policy rate and emergency lending — and later, when the policy rate got stuck at its lower bound of zero, it turned to alternative forms of monetary stimulus. These included "forward guidance"— communicating its "lower-for-longer" plans to market participants — "quantitative easing" (QE), and "Operation Twist." Respectively, these largely involved the purchasing of longer-term securities, including Treasuries and mortgage-backed securities (MBS) from government-sponsored entities, and extending the maturity of the Fed's bond portfolio.

While some of these actions are behind the motivations for this hearing, my assessment of their impact, presented in some detail in my July testimony, is that they were effective in offsetting the historically large demand contraction that followed the crisis. Looking at the full spate of monetary interventions described above, Blinder and Zandi find that in 2014, real GDP was 5 percent higher than it otherwise would have been; the level of payroll employment was 4 million jobs above the alternative; the unemployment rate was more than 2 percentage points lower against a counterfactual of no intervention.

I also cited research that tries to isolate the impact of quantitative easing, including bond purchases that would not be permissible — agency MBS purchases — under some of the legislation under discussion today. John Williams argues that "the central tendency of the estimates [of QE] indicates that $600 billion of [the] Federal Reserve's asset purchases lowers the yield on ten-year Treasury notes by around 15 to 25 basis points. To put that in perspective, that is roughly the same size move in longer-term yields one would expect from a cut in the federal funds rate of 3/4 to 1 percentage point." This too led to faster GDP growth and lower unemployment. As I noted in July, "Williams reports on research that finds the Fed's [large-scale asset purchase] program lowered the unemployment rate by one-quarter of a percentage point, which in today's labor market amounts to 400,000 jobs. Blinder and Zandi, using a macro-model to score QE against a baseline with no such intervention, estimate that from 2009 to 2014, QE lowered the 10-year Treasury rate by 1 percentage point and raised the level of real GDP by 1.5 percent." Other research I cited found that the Fed's MBS purchases lowered mortgage rates by roughly 100 to 150 basis points, which the researchers (Hancock and Passmore) attributed to both the announcement of a "strong and credible government backing for mortgage markets" and the actual purchases themselves.

Post-recession, the Fed continued to promote the recovery and unemployment fell to what is now the lowest jobless rate in 17 years. At least until recently, the central bank has been admirably data-driven (some analysts, including myself, have questioned recent rate hikes given low and decelerating core prices and non-accelerating wage growth); Chair Yellen, in particular, has carefully and extensively articulated the bank's thinking and its plans. The job market is solid, with average job gains of 190,000 per month over the past two years. Financial markets are particularly strong, boosted by strong corporate earnings, and perhaps expectations regarding upper-end tax cuts. Of course, all is far from perfect: the Fed has consistently undershot its 2 percent inflation target, and wage growth is slower than many analysts would expect at 4.1 percent unemployment. Slow productivity growth is another serious shortcoming of the current expansion, but economists have little understanding of that phenomenon, and I'm not aware of a credible argument that links this result to any central bank policies.

In other words, if I were looking around Washington for an institution that fits the adage "If it ain't broke, don't fix it," my first stop would be the Federal Reserve, and frankly, I'm not sure where, if anywhere, I'd go next.

That said, some of the Fed's actions during the recession, particularly its invocation of the rarely used section 13(3) in its charter (the part that allows the Fed to engage in emergency lending), raised legitimate concerns about the creation of moral hazard. Also, even if we agree that the Fed performed well in the last crisis and recovery, we cannot know how future Feds would respond. I turn to these concerns next.

Proposal: Congressional Accountability for Emergency Lending Programs Act

The motivation for this proposal appears in large part to be to reduce the moral hazard invoked when the Fed provides emergency liquidity to illiquid financial institutions ("moral hazard" occurs when an economic entity — a person or an institution — is protected against a risk such that it has an incentive to ignore the consequences of its risky actions). The proposal intends not to eliminate the Fed's lending authority, but to significantly raise the procedural bar to its implementation. Though I recognize the motivation for the proposal, I see two major drawbacks. First, since the crisis, Congress legislated the Dodd-Frank financial reforms, key sections of which were designed specifically to reduce the need for Fed intervention in this space. Some of these measures remain untested (others appear to be working and are keeping the financial system safer than it was), but I see no reason to add new complexities into this system until we give the Dodd-Frank measures a chance. Second, and this is a profound concern with the proposal, it takes the authority for emergency lending outside of the Fed and requires both chambers of Congress to provide a timely (30-day) approval of the Fed's emergency loans. I believe this adds unnecessary risk to credit markets and the broader economy.

The proposal increases the minimum number of Fed officials who must authorize an emergency lending intervention from five members of the Board of Governors to eight members of the Federal Open Market Committee (FOMC). It introduces numerous new rules regarding the types of securities the Fed can accept from loan recipients, how the Fed determines the sufficiency of collateral, and it specifies how the Fed must construct a penalty rate at which to lend from its emergency facilities, along with various other technical requirements.

Some of these ideas warrant consideration, e.g., raising the minimum member requirement, while others may be ill-advised. The penalty rate is specified as the sum of an average of a discount rate across all Fed banks and the average spread between distressed corporate debt and a yet-to-be-determined bond index. This is a highly opaque construct that may or may not serve the purpose of the penalty rate, which is to charge a premium above market rates to (a) avoid crowding out private lending, and (b) penalize lenders that systemically underpriced risk. The prescribed formula could return an overly punitive rate that would potentially undermine the Fed's "lender of last resort" function. For example, it is not hard to imagine a crisis that "blew out" corporate spreads, which, according to the proposal, would have to be embedded in the penalty rate. Thus, here again, the proposal mistakenly takes decisions outside of the Fed at risk to the nation's credit system at a time of great stress. Moreover, I am not aware of compelling evidence that the Fed underpriced its penalty rate in the recent crisis, so this is another example of "don't fix what isn't broken."

But my main concern about this proposal is the establishment of procedures for congressional approval of emergency credit. This is a sharp departure from the lending authority established in section 13(3) of the Fed's charter, one that undermines both the independence of the institution and its role as lender of last resort. With this change, the 535 members of the Congress all become lenders of last resort, a possibility I strongly urge this committee to avoid.

If Congress fails to approve an emergency lending program within the 30 days, the borrower, which, by definition, is facing a balance-sheet crisis, must pay the loan back to the Fed. Moreover, members of Congress and their staffs must quickly engage in highly technical analysis of whether lending institutions are illiquid or insolvent, and of the quality of their collateral. Such analysis, to be clear, is standard, ongoing practice at the Fed, but by insisting Congress engage in it as well, the proposal introduces the possibility of politicizing the analysis and, if Congress fails to act in a timely manner, triggering significant market disruptions. Regarding this last point, consider also that there is a strong likelihood these newly required evaluations would be occurring in the midst of a pervasive economic shock, if not a recession, meaning Congress would have many other difficult matters requiring its attention.

To be clear, I do think the bar should be high for approval of emergency lending, but my bottom line is clearing that bar should be the purview of the Fed, not the Congress. Thus, should the committee consider raising the *internal* bar (i.e., internal to the Fed), while this should be done carefully with great attention to potential unintended consequences, it is consistent with prudent congressional regulation. Conversely, raising the *external* bar by requiring congressional approval goes beyond that benchmark.

Turning to my view that provisions of Dodd-Frank potentially obviate the proposal, consider recent writings on this point by Fed chair during the financial crisis, Ben Bernanke. He notes that (my bold):

> The Fed intervened in the cases of Bear and AIG with great reluctance, doing so only because no legal mechanism existed to safely wind down a systemic firm on the brink of failure. A key element of the Dodd-Frank financial reform bill…was to provide just such a mechanism — the so-called orderly liquidation authority, which gives the Federal Deposit Insurance Corporation and the Fed the necessary powers to put a failing firm into receivership without creating financial chaos…. With the creation of the liquidation authority, the ability of the Fed to make loans to individual troubled firms like Bear and AIG was no longer needed and, appropriately, was eliminated. **As Fed chairman, I was delighted to see my institution taken out of the business of bailing out failing behemoths.**[2]

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[2] Ben S. Bernanke, "Warren-Vitter and the lender of last resort," Brookings Institution, May 5, 2015, https://www.brookings.edu/blog/ben-bernanke/2015/05/15/warren-vitter-and-the-lender-of-last-resort/.

In addition, Dodd-Frank created a vice-chair for financial supervision (currently held by Randal Quarles). It added restrictions to the Fed's 13(3) authority by requiring: (1) the Treasury Secretary to approve any lending; (2) loans to be open to a broad class of borrowers and not to any one individual borrower; (3) the names of borrowers to be disclosed to Congress within a week; and (4) stricter standards for loan collateral. Dodd-Frank required the U.S. Government Accountability Office (GAO) to do a one-time audit of the Fed's numerous emergency lending facilities that were established during crisis, leading to seven recommendations to the Fed "to strengthen policies for managing noncompetitive vendor selections, conflicts of interest, risks related to emergency lending, and documentation of emergency program decisions," which the Fed agreed were worthy of implementation (the committee would be well-advised to follow up on its progress). Dodd-Frank, along with recent international accords under Basel III, have increased what many financial analysts consider the first line of defense against illiquidity/insolvency crises: capital requirements that disallow excessive leverage.

The best way to avoid emergency lending by the Fed is to avoid credit bubbles, systemically underpriced risk, and the crises that follow these financial pathologies. And the way to achieve that is through market oversight and regulation. Of course, even with robust oversight, crises can occur, but I'd urge the committee not to involve Congress in the granular analysis and approval of emergency lending, but to monitor the effectiveness of regulatory measures currently in place, albeit as yet untested.

In reviewing a proposal much like this one, here's how Bernanke described his concerns, similar to the ones I just raised: "[T]heir approach is roughly equivalent to shutting down the fire department to encourage fire safety…. Rather than eliminating the fire department, it's better to toughen the fire code." President Trump's nominee for Fed chair, Jerome Powell, recently made a similar point: "Further restricting or eliminating the Fed's emergency lending authority will not prevent future crises, but it will hinder the Fed's ability to limit the harm from those crises for families and businesses."

In this regard, it is of great concern that some members of Congress want to get rid of or defang Dodd-Frank. While such a complex law certainly requires monitoring and improving, broad deregulation of financial markets is completely contraindicated in any case. To do so while also adding the members of Congress to the list of lenders of last resort would be an extremely reckless act of economic policy.

Proposal: Independence from Credit Policy Act

The main purpose of this proposal appears to be to restrict the Fed's debt purchases to Treasury bonds. Thus, had this proposal been in place in the financial crisis, the Fed would not have been able to purchase agency MBS. This would have been a serious mistake that would likely have prolonged the downturn, which was, of course, triggered by the bursting of housing bubble that ultimately shut down the flow of credit to the housing sector, a key sector of the economy.

In fact, John Williams of the San Francisco Fed has argued that the MBS purchases were the "most effective" part of the Fed's asset purchase programs and that they "ended up having kind of the bigger bang for the buck than the Treasury purchases." Blinder and Zandi's research, cited above, underscores these findings: "within a short time," the MBS purchases by the Fed meant that "homebuyers with good jobs and high credit scores could obtain mortgages at record low rates, which helped end the housing crash."

Economist Josh Bivens, in recent testimony before the Financial Services Committee, underscored a broader theme as to why this proposal would be misguided:

> The key insight behind recognizing that QE needed to go beyond simple Treasury purchases to be most effective is simply that there is not just one "interest rate" in the economy. Instead, there are multiple interest rates, and even multiple long-term interest rates. And expansionary monetary policy should aim to reduce those long-term interest rates most relevant to households' consumption and firms' investment decisions – and these are not the Treasury rates. Putting downward pressure on Treasury rates should result in these other rates coming down as well, but there are times when the risk premium to assets that aren't Treasuries rises substantially (say in the aftermath of the Great Recession and the related financial crisis), and simply pulling down only Treasury rates would not be the most effective way to conduct monetary policy.

In the spirit of Bivens' insight, I would encourage the committee to consider the following. Uniquely among central banks, the U.S. Fed is, with minor exceptions, restricted to purchasing bonds solely from the U.S. Treasury and the GSEs. In this sense, we were "lucky" that the cause of the recession was the bursting of the housing bubble, as a channel existed by which the Fed could prevent the excessive tightening of credit in that sector.

As I noted the last time I testified on this topic, the banks of England, Japan, Canada, and Europe all have few restrictions on the types of assets they can purchase (though in some cases they must seek permission from regulators to go into, for example, equity markets). This creates flexibility for their central banks to bring the water to the specific source of the fire, based on which sector experiences a credit crisis. Because such flexibility would be a large change in the U.S. case, my suggestion here is that the committee may want to study the practices of these other banks and consider their results in the traditionally more constricted US context.

Bivens' comment correctly suggests that in today's interconnected, global capital markets, we do not know from which sector the next credit crunch will emanate. Thus, this may be a particularly imprudent time to narrow the space of the Fed's sectoral interventions. This observation is also worth considering in the context of the rule in the emergency lending proposal that loans should only be made to firms providing financial services. That rule represents a very significant reduction of the scope envisioned in 13(3) of the Fed's existing charter, and it may also be too restrictive.

Additionally, I urge the committee to consider adding one other type of allowable debt to the Fed's portfolio: municipal debt. Though this would require, I believe (others question this assertion), a change in the law governing allowable Fed purchases, this would be a safe way to offset recessions at localized levels while stimulating potentially productive building and the creation of good-quality jobs (the Fed is allowed to purchase municipal debt, but only up to maturities of six months; this would have to be significantly extended for this idea to be operational).[3]

[3] Joseph A. Grundfest, Mark A. Lemley, and George G. Triantis, "Getting More Bang for the Fed's Buck," *New York Times*, October 23, 2012, http://www.nytimes.com/2012/10/24/opinion/why-the-fed-should-buy-munis-not-mortgages.html.

Proposal: Monetary Policy Transparency and Accountability Act of 2017

This proposal introduces the following language: "The [FOMC] shall annually establish exactly 1 monetary policy strategy, which shall serve as a non-technical public communication of the Committee's consensus expectation for the conduct of monetary policy during that calendar year." The central theme of my recent testimony to this committee focused on why this was an impractical, and even unworkable, idea. However, I should note that the current proposal is less burdensome than the one under discussion last summer (the Fed Oversight Reform and Modernization Act), as it does not require a specific rule nor outside regulatory approval for changes in how the Fed employs rule-based monetary policy. In this case, the proposal encourages more of the type of transparency and public communications in which the Bernanke and Yellen Feds were already well engaged, though with an emphasis on rule-based strategies. Such communication is, in fact, a clear positive development for Fed policy and should be further encouraged.

As regards rule-based interest-rate setting, there is clearly a role for benchmarking FOMC decisions against rules like variations on the well-known Taylor Rule. In fact, my recent testimony argued that, "One of the first questions a monetary economist might ask in assessing the stance of Fed policy is, 'where is the Fed funds rate relative to the Taylor rule?' However, while this might well be the first question, it should definitely not be the last."

There are many reasons for flexibility. First, there's no consensus as to which version of the Taylor Rule, or any other rule, should be the "exactly one strategy" noted in the proposal. My testimony raised actively debated questions of which inflation gauge should be used, which coefficients are most appropriate, what should be the Fed's target inflation rate (more on this in my conclusion), and which output gap or "neutral" interest rate should be used (note that these variables are "unobservable"; they must be estimated by analysts and there is no consensus on the best way to do so; also, they clearly change over time). The Fed also must use real-time data, and it needs to have the flexibility to discount data it believes will be significantly revised.

Moreover, when an economist defends rule-based interest rate setting, he or she tends to show how their preferred formula follows the actual part of the federal funds rate (FFR). But no one should take solace from such comparisons as they embed the strong assumption that the path of the FFR was the optimal one for that period and, an even stronger assumption, that this path should dictate the parameters for the optimal path in a later period.

The table below, updated from my earlier testimony, shows the broad range of formula-based interest rates that would have prevailed in the trough of the Great Recession, and those that would prevail now. Note the ranges in both columns: from -0.6 to -6.6 percent in the recession, and from 1.1 to 4.1 percent now. I would certainly hope no member of this committee would endorse the high end of that range in the current expansion, one that would surely slam the brakes on a healthy expansion with very low — even too low — inflation.

TABLE 1

Rule No.	A Surplus of Taylor Rules	Low during Great Recession	Now
1	Standard Taylor Rule	-1.8%	3.4%
2	(1) but with PCE core; r* = 0%	-2.8%	1.1%
3	(2) but with slack coef = 1	-6.6%	1.2%
4	(1) but with u - u* instead of GDP gap	-0.6%	4.1%
5	(3) but with u - u* instead of GDP gap	-4.1%	1.8%
N/A	**Actual FFR**	**0.0%**	**1-1.25%**

Source: Author's analysis of data from the Federal Reserve, Bureau of Economic Analysis, Congressional Budget Office, and Ben Bernanke

So, to the extent that this proposal leads the Fed to increase its communication and the transparency of its operations, it is worth a close look. But any veering into legislating rule-based policymaking, with granular oversight from regulators outside the Fed, should be assiduously avoided.

Conclusion

The sound and reasonable motivation of these proposals is to limit moral hazard and to clarify the transparency of the actions of the Fed, one of our most important economic institutions. I've tried to highlight the tradeoffs invoked by the proposals, as there is, of course, a delicate balance between greater Fed oversight and limits on the one hand, and its political independence and efficient function, especially amidst crises, on the other.

There are, however, at least two areas the proposals do not touch on where I believe the Fed could improve its operations, both of which bear on issues raised by the proposals. First, the fact that the Fed has undershot its inflation target of 2 percent signals a significant problem, both with the institution's understanding of the forces driving prices and the effectiveness of its monetary policy. My testimony reveals that I am a strong supporter of the Fed and its actions in recent years, and yet it is frustrating to hear governors consistently, and, at least thus far, incorrectly, aver that any day now, key variables will start behaving as they predict. Clearly, a rethink is necessary, and many analysts, including myself, have called for the Fed to consider changes to how it targets inflation. These ideas include a higher inflation target or target price levels (or levels of other aggregates, like nominal GDP or the wage base). Former Fed Chair Ben Bernanke recently introduced an interesting hybrid: a temporary price level targeting approach that would kick in only when the funds rate was at or near the zero lower bound.[4]

Next, as noted in my testimony, despite internal warnings, the Fed missed the housing bubble, and the ensuing financial crisis and deep recession had severe, lasting consequences for both our economy and our politics. This should also be an area where the central bank significantly improves its performance. Dodd-Frank reforms, discussed above, should be helpful in this regard, as they create greater oversight functions and introduce rules for monitoring leverage, such as "stress tests"

[4] Bernanke, "Temporary price-level targeting: An alternative framework for monetary policy," Brookings Institution, October 12, 2017, https://www.brookings.edu/blog/ben-bernanke/2017/10/12/temporary-price-level-targeting-an-alternative-framework-for-monetary-policy/.

and higher leverage requirements. But more could be done here, as Baker and Bivens argue in a recent brief.[5] They suggest three functions that would improve the Fed's bubble-watch capacity, including communicating warnings regarding large asset bubbles in key areas, accompanied by warnings that the Fed will take steps to deflate the bubble; deleveraging, which could include higher margin requirements; and stepped-up bank supervision, as per Dodd-Frank sorts of requirements. But the first step must be for the bank to recognize that it does not have the luxury to maintain a view that recognizing and deflating systemic bubbles are outside of its purview, and that its job is solely to mop up the damage.

Allow me to close with a comment not on monetary policy, but on its very important complement in weak economies: fiscal policy. As I stressed in my last testimony, the policies of the central bank cannot offset downturns, especially deep ones, on their own. They can boost liquidity and lower the cost of credit, but fiscal policy is an essential demand-side ingredient if we want households and businesses to take advantage of less expensive and more readily available credit. In this regard, the pivot to austerity — fiscal consolidation in downturns or weak recoveries — was a significant headwind to the recovery following the Great Recession. Moreover, the debt-increasing tax cuts currently under consideration by this Congress are extremely ill-advised in this context. Even absent recessions — a highly unrealistic assumption, of course — just based on our aging demographics, we are going to need more, not less, revenue in the future. And in the context of the next recession, it will be much harder to implement essential fiscal policies if deficits and debt levels are rising.

[5] Dean Baker and Josh Bivens, "The wrong tool for the right job," Economic Policy Institute, May 5, 2016, http://www.epi.org/publication/the-wrong-tool-for-the-right-job-the-fed-shouldnt-raise-interest-rates-to-manage-asset-bubbles/.