The Fed and Its *Critics*

Both ends of the political spectrum take aim.

By John M. Berry

The conservative Republican chairmen of the House Financial Services and Senate Banking committees continue to press for legislation to curb the Federal Reserve's power to respond to future financial crises. They also want to force the central bank to adopt a rule to govern its monetary policy decisions. Under the rubric of "Fed reform," they thus want to take away some of the key powers the central bank used, first, to keep the United States from falling into a depression in the wake of the financial crisis that began in 2007, and, second, to bolster the slow recovery over the past six years.

Meanwhile, Senator Elizabeth Warren, the Massachusetts Democrat who is at the other end of the conservative-liberal scale, is also pushing legislation that would make lending to the largest banks during a crisis all but impossible. Her goal, she says, is to prevent "backdoor bailouts." Former Fed Chairman Ben S. Bernanke says her bill would mean the central bank would no longer be able to play its fundamental role as the nation's lender of last resort.

The Republican committee chairmen, Senator Richard Shelby of Alabama and Representative Jeb Hensarling of Texas, complain constantly that the Fed has abused its powers and failed to keep Congress and the public informed about what it is doing and what it plans for the future.

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Senator Richard Shelby (R-AL)

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“One way our economy could be healthier is for the Federal Reserve to be more predictable in the conduct of monetary policy,” Hensarling said just before Fed Chair Janet L. Yellen presented the central bank’s semi-annual monetary policy report in July. “During periods of expanded economic growth like the Great Moderation of 1987–2003, the Fed followed a more clearly communicated, understandable, and predictable convention or rule. America prospered.”

“Today we’re left with so-called ‘forward guidance,’ which unfortunately remains somewhat amorphous, opaque, and improvisational. Too often, this leads to investors and consumers being lost in a rather hazy mist as they attempt to plan their economic futures and create a healthier economy for themselves and for us all.”

This hyperbole is mostly wrong, with Hensarling badly misreading Federal Reserve history. Alan Greenspan was chairman for that entire 1987–2003 period, and under his leadership did not follow any announced rule in making monetary policy decisions. For instance, in the latter half of the 1990s when unemployment fell below 4 percent, Greenspan stood firm against raising interest rates significantly because he became convinced that surging productivity growth would hold inflation at bay. As it turned out, he was correct and the episode convinced many skeptics that under some circumstances low joblessness did not necessarily lead to high inflation. It was also a period in which Greenspan’s and the policymaking Federal Open Market Committee’s discretion produced a better result than a policy rule would have—though the Fed was criticized for not raising rates quickly enough to burst the bubble in tech stock prices.

A variation on that theme of the Fed not raising rates quickly enough has played out since the crisis-induced recession ended five years ago. After the Fed lowered its target for overnight interest rates effectively to zero in December 2008 and kept it there, Fed critics loudly complained that the policy would soon generate high inflation and demanded a quick increase in rates. Now, almost seven years later, there is still no runaway inflation. Following the policy rule apparently most popular with congressional critics, the Taylor rule formulated by John B. Taylor of Stanford University, would have required the Fed to begin raising rates several years ago.

In other words, it is fair to say that Hensarling and Shelby implicitly have been calling for years for higher interest rates to head off an inflation surge that still hasn’t arrived. The origins of this fight, in fact, can be traced backed to efforts to force the Fed to concentrate on inflation rather than the maximum employment part of the central bank’s dual legal mandate, with some critics urging that the employment goal be dropped. Suppose that had happened. Would Fed officials have believed they had the legal right to use many of the unconventional methods, such as quantitative easing—the purchase of Treasury and mortgage-backed securities to lower longer-term interest rates—to improve

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lagging economic growth after the recession ended? Of course, use of such methods is one of the major complaints of those pushing for Fed "reform."

Yellen has said repeatedly that the Fed should have and does have a systematic approach to monetary policy in seeking to reach the dual goals. A specific rule is unnecessary, particularly one with just two variables, inflation and unemployment, as the Taylor Rule does, she argues.

At a July House Financial Services monetary policy subcommittee hearing, John H. Cochrane, an economist and blogger at the Hoover Institution at Stanford University, supported requiring the Fed to follow a policy rule eschewing unusual actions such as quantitative easing. Furthermore, he said, the central bank should not be trying to influence stock prices and mortgage interest rates or pushing investors to make more risky investments when they might otherwise be buying Treasuries, a channel through which quantitative easing can influence the economy. Congress is right to be considering reining in the central bank, he said.

But Cochrane surprisingly then offered the Fed a true encomium:

"In part, monetary policy is not, now, obviously broken," he declared. "The outcomes we desire from monetary policy are, one must admit, about as good as one could hope. Inflation is basically nonexistent. Short-term rates are as low as we have seen in two generations. The labor market is functioning normally. Economic growth has been steady and bond markets quiet.

"Yes, growth is far too slow," Cochrane continued. "Not enough people participate fully in the labor force, wages are stagnant, and we face many other economic problems. But these are problems that the monetary policy really can't do much about. Congress asked for price stability … maximum employment and low interest rates, and we got them… This benign outcome is, one has to admit, a bit of a puzzle."

Perhaps the real puzzle is why the politicians and economists such as Cochrane are convinced that adopting a monetary policy rule would have improved on that outcome, or that it would do so in the future. They certainly have no evidence that a policy limited by some rule would have produced a better result. All they have are assertions based in part on a skewed view of the actual course of policy during the Great Moderation.

Taylor and Paul H. Kupiec of the American Enterprise Institute also testified at the subcommittee hearing and supported the notion that the Fed's wings should be clipped to one degree or another. The subcommittee chairman, Representative Bill Huizenga, a Michigan Republican, issued a press release quoting the three, calling them "Topline" witnesses. Underscoring the fiercely partisan nature of the proceeding, he failed to mention much less quote the other witness that day, former Fed Vice Chairman Donald Kohn, now a senior fellow at the Brookings Institution and an external member of the Financial Policy Committee at the Bank of England.

Kohn told the committee that the long list of proposed legislative changes that would affect the Fed "would make important changes in the character of the institution, its policy processes, and its authorities." A separate bill

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would create a commission to study how the Fed could be made more effective. "The basic premise of both of these strands is that something has been seriously amiss with the way the Federal Reserve has carried out the responsibilities Congress has given it."

"I do not agree with that premise," Kohn said. "In my view, the actions of the Federal Reserve in the crisis and slow recovery were necessary and appropriate. Its conduct of monetary policy has been as systematic as possible under unprecedented and constantly evolving circumstances, and it has been especially transparent about how those monetary policy actions were expected to foster achievement of its legislated mandate and what it would be looking at in the future to gauge the need for future actions."

A standard complaint of the Fed critics, of course, is that the central bank's monetary policymaking process is opaque, and that it should be "audited" by the Government Accountability Office. That agency already audits all the financial aspects of the central bank but not monetary policy. A quarter-century ago or more, the complaint about opaqueness was valid. In those days, the Fed usually did not even disclose changes in its policy stance or even changes in what monetary measure it was targeting.

What's really missing in all of these debates is what economists call a counterfactual—what would have happened if the Fed and the Treasury had not taken all those unconventional steps to keep the financial system from imploding.

But beginning in 1994, announcements of policy decisions gradually began to be made, minutes of the policymaking Federal Open Market Committee meetings released, votes on policy were disclosed, and press conferences began on a regular basis. Even earlier transcripts of FOMC meetings had been made available with a five-year lag. Monetary policy reports are made twice a year to Congress and the chair appears before the House and Senate banking committees to present them. Senator Shelby has largely ignored all those sources of readily available information and complained last February, for instance, that the European Central Bank has more press conferences. He did not note, however, that only two days earlier the ECB for the first time ever published minutes of a meeting of its policy setting Governing Council, or that no information about its votes is made public.

In addition to all the official communications, most members of the Fed Board and the dozen regional reserve bank presidents routinely make speeches, attend conferences and seminars, and so on during which they express their own views.

A week before Cochrane and Kohn testified, Alice Rivlin, another former Fed vice chairman, former deputy director of the Office of Management and Budget, and the first director of the Congressional Budget Office, addressed many of the same issues before yet another House Financial Services subcommittee. The hearing's title was "Fed Oversight: Lack of Transparency and Accountability."

Rivlin questioned the premise of the hearing, saying, "Current monetary policy alternatives are controversial, but they are not mysterious or opaque, and Federal Reserve officials are making extraordinary efforts to explain to Congress and the public the dilemmas they face."

The current issue the Fed must decide, Rivlin said, is "when to begin raising short-term interest rates and how fast to bring those rates back to a more normal range. Like most monetary policy decisions, this is a judgment call, and views differ, both inside and outside the Fed… Different people weigh the factors differently, but there is nothing obscure or inscrutable about this dilemma," she said, adding, "Nothing terrible or irreversible is likely to

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happen if the Fed acts too slowly or too fast. Threats to our future prosperity are more likely to come from fiscal gridlock."

Indeed, if Congressional conservatives, particularly in the House, had been willing after the recession's end to accept a federal fiscal policy similar to what previous Congresses had put in place following earlier recessions, the Fed might not have felt it necessary to engage in many of the unconventional monetary policies against which Shelby, Hensarling, and their supporters now rail.

Again, in a spirit of being as open as possible with Congress and the public generally, Yellen has said she expects the Fed's interest rate target to be raised before the end of the year, if the labor market continues to improve and inflation appears likely to rise toward the 2 percent target. But she and other officials also emphasize that the timing of the decision will depend on data. She has also emphasized that the timing of the so-called liftoff is much less important than the path for rates over the next two or three years. A majority of Fed watchers and investors appear to believe that the first increase will come at the FOMC meeting in September, though others expect it in December.

Is that information "opaque"? Hardly. There have been a couple of episodes when the markets reacted in unexpected ways to a Fed action or to comments from a Fed official. But as Kohn testified, "The pricing of actual and expected volatility in financial markets has not suggested an unusual amount of uncertainty about the path of interest rates or the Federal Reserve's portfolio holdings going forward."

The other piece of legislation being pushed in the House which Kohn mentioned would create a body called the "Centennial Monetary Commission." The name refers to the fact that the Fed was created in 1913 and went into business the following year. The author of that bill, Representative Kevin Brady, a Texas Republican, also introduced a bill in March 2012 called "The Sound Dollar Act," which if passed would end the Fed's dual mandate of maximum employment and stable prices, replacing it with a single goal of stabilizing the value of the dollar in terms of gold.

The Centennial Monetary Commission's writ would be broader than that. It would be directed to analyze different approaches to setting monetary policy using discretion; targeting the price level, the inflation rate, growth, or level of nominal gross domestic product; some monetary policy rule; or the gold standard. And it would examine the Fed's lender-of-last-resort function. In short, it could look into anything the Fed has ever done or might do.

The notion of such a commission was an extension of the effort by conservatives to force the central bank to behave as they see fit—and in particular to elevate holding down inflation as the only important function of the Fed. The gold standard, which was the keystone of much of the world's monetary system in the nineteenth and early twentieth centuries, eventually collapsed during the Great Depression of the 1930s. After an episode of very high inflation at the end of the 1970s, political pressure to again introduce gold into the U.S. monetary system to help curb inflation led to appointment of a Gold Commission by President Ronald Reagan in 1981. In its report the following year, a majority of the commission rejected the use of gold "as a fruitful method for dealing with the continuing problem of inflation."

Just to make sure that the Centennial Commission would reach the right conclusions, Brady's legislation would create a twelve-member commission with four members each appointed by the majority party in the House and the Senate and only two by the minority party. In other words, under current circumstances, eight Republican appointees and four Democrats.

Perhaps the real puzzle is why the politicians and economists are convinced that adopting a monetary policy rule would have improved on that outcome, or that it would do so in the future.

In the short run, probably the most dangerous legislation both to the Fed and its ability to do its job in some future crisis is Warren's bill, which is co-sponsored by Senator David Vitter, a Louisiana conservative Republican. In a blog published by the Brookings Institution where Bernanke is a senior fellow, the former Fed chairman noted that the central bank was created in 1913 "in large part to serve as a lender of last resort and thereby reduce the incidence of banking panics in the United States." The bill would undermine that ability, he said.

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Before the Fed could lend, it would have to determine that an institution was solvent, which it normally would do anyway. But to would then have to make its analysis public immediately.

"The problem is what economists call the stigma of borrowing from the central bank," Bernanke wrote. "Imagine a financial institution that is facing a run but has good assets usable as collateral for a central bank loan. If all goes well, it will borrow, replacing the funding lost to the run; when the panic subsides, it can repay. However, if the financial institution believes that its borrowing from the central bank will become publicly known, it will be concerned about the inferences that its private-sector counterparties will draw. It may worry, for example, that its providers of funding will conclude that the firm is in danger of failing, and, consequently, that they will pull their funding even more quickly. Then borrowing from the central bank will be self-defeating, and firms facing runs will do all they can to avoid it."

What's really missing in all of these debates is what economists call a counterfactual—what would have happened if the Fed and the Treasury had not taken all those unconventional steps to keep the financial system from imploding. Suppose institutions such as Citigroup, American International Group with all its regular insurance subsidiaries, or Merrill Lynch had been allowed to fail. Suppose the House had rejected rather than approved the Troubled Asset Relief Program after first rejecting it. It would have been a global financial disaster with joblessness rising not just to 10 percent but far higher. State and federal government budget deficits would have exploded. Stock prices would have tumbled even further than they did.

Those are the things that all the politicians wanting to "reform" the Fed ought to have in mind. ◆