Testimony before the Joint Economic Committee hearing on "The Fed at 100: Can Monetary Policy Close the Growth Gap and Promote a Sound Dollar?"

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Thank you, Chairman Brady and Vice-Chair Klobuchar, for the opportunity to appear before you and your colleagues today. I commend you and the Joint Economic Committee for calling a hearing on this topic. It is right in a democratic society that independent central banks be accountable to elected officials for their performance and—over sufficiently long intervals to allow for sound judgments—for the goals they pursue. One hundred years seems like it would be a more than sufficient length of time for so doing, as would the 35 years since the 1978 Full Employment and Balanced Growth Act, to pick another anniversary. I would argue such a review is due nearly five years since the financial crisis and Great Recession began.

I would like to make three arguments today regarding the topic of today's hearing, the right goals for the Federal Reserve:

- the difference between goal and instrument independence for central banks;
- the need for practical targets rather than broad mandates or narrow rules;
- the necessity of responsible monetary policy to close the growth gap.

Accountability for Central Bank Goals

Independent central banks, like the US Federal Reserve System, should have only instrument independence, meaning the ability to set monetary policy at any given policy board (i.e., FOMC) meeting or string of meetings without interference from politicians; they should not have goal independence, meaning the ability to set their own priorities for policy over the medium term.[2] The members of this Committee are well familiar with the arguments for maintaining the Federal Reserve's instrument independence. Without it, price stability and a sound dollar would be very difficult to maintain, and the sustainable growth of the US economy would be reduced. So we can all agree to maintain that kind of independence for the Federal Reserve.

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[2] This distinction was drawn by Stanley Fischer in Debelle and Fischer (1994) and Fischer (1995).

Central banks which have goal independence, however, give up too much democratic accountability for too little gain on credibility, and raise the possibility of capricious policymaking which would be destabilizing. Goal independent, and therefore too independent, central banks also raise political tensions inherently and justifiably with citizens who feel their well-being is affected by an unchecked institution. In addition to being a problem in itself, such tensions will undermine any policy commitments made by that central bank.

So the deal between an (instrument) independent central bank and the elected officials overseeing said central bank has be two-way. The central bank should be subject to having its goals reset by the responsible officials for multi-year periods, and having its performance judged subject to those publicly defined policy priorities between reviews of its goals. The elected officials, in turn, have to restrain themselves from using the threat of resetting the central bank's goals just for the sake of getting a politically motivated short-term policy change by the central bank. That kind of bullying pressure would harmfully interfere with instrument independence, while discrediting legitimate public discussion of the central bank's goals. Changing goals too often would undermine stability and credibility. Both would increase inflation and inflation volatility.

I know this Committee recognizes the worth of distinguishing between constructive l0ng-term review of the Federal Reserve's goals, and abuse of the Congress' right to review the Federal Reserve's goals for short-term gain. I hope the other relevant committees in Congress will follow your lead in respecting this distinction, and act accordingly in this regard. We have just seen three examples abroad of reviews of independent central banks' goals, which illustrate the stakes of so doing.

- In January in Japan, the Abe Government reset the Bank of Japan's inflation target, and explicitly criticized the Bank's past leadership for failing to actively pursue the target over a period of nearly 20 years. They waited until the previous Bank of Japan Governor had completed his term of office, thereby respecting the Bank's instrument independence, before replacing its leadership with a group that would pursue the publicly set goals. (Think of Lincoln promoting Grant to run the Union Army.) Since their appointment in mid-March, both government debt and stock markets in Japan have responded very positively. This illustrates how transparent accountability for central banks and goal resetting by politicians can be managed while enhancing (not eroding) monetary credibility.

- Last December in the United Kingdom, the Chancellor of the Exchequer announced a review of the Bank of England's inflation targeting framework after 15 years in place. There was a set date by which the Chancellor would publicly report any proposals for change resulting from the review. The review by elected officials came after three major independent evaluations of different aspects of Bank of England's performance in recent years, commissioned by the Chancellor, were published. In March, the Chancellor announced changes to the execution of the Bank's remit, particularly with respect to the short-term pursuit of growth and the use of forward-guidance, and otherwise largely endorsed the existing inflation target framework. Markets treated this announcement as largely a non-event, rather than as a disappointment, which is right. This demonstrates that, even after serious public review involving expert opinion, deciding *not* to make major changes to the central bank's goals is a valid path rather than acting just for change's sake alone.

- The contrast is clear with what has happened in Hungary. In March, the Hungarian Prime Minister altered the central bank law and the composition of the National Bank of Hungary's policy board. The new governor he put in place dismissed a number of senior staff. Transparency was reduced while the notional inflation target was supposedly unchanged. The European Central Bank and IMF have expressed concern about the removal of the central bank's independence. The uncertainty about the politicization of monetary policy has deepened Hungary's financial difficulties. Review of goals should not be legislative takeovers.

I hope my discussion gives the Committee a clearer sense of what is the right spirit and the right limits within which to conduct a public review of the Federal Reserve's policy priorities and goals, at least insofar as I read the historical and recent experience. I believe this is relevant to keep in mind, not just for today's and similar hearings, but especially if Chairman Brady's proposal to have a Centennial Monetary Commission goes forward. I support such reviews, within the aforementioned limits and spirit, as enhancing rather than impairing the exercise of central banks' instrument independence. Legitimacy and clarity make for better monetary policy.

Monetary Mandates, Policy Goals in Practice, and the Limits of Rules

So responsible elected officials should review the policy goals of independent central banks at multi-year intervals, announce any changes (or not) to those goals, and then compel compliance by the central bank's policy board with the pursuit of those goals. Note that I said "pursuit of those goals." This is because you cannot always achieve what you want through monetary policy, even with the best of intentions and commitment. The evaluation of whether the central bank leadership did as well as they should and could have in such pursuit is a more recurring duty, and the usual role of Congressional oversight of the Federal Reserve.

I emphasize the word "pursuit" of the set or re-set policy goals for another reason as well, more directly relevant to the focus of today's hearing. Goals have to be practical to be meaningful, as much in monetary policymaking as in any other area of government and public policy. Broad aspirational mandates can cause trouble, by setting unreasonable expectations, leading to politicized definitional debates, or simply confusing the policymakers as a guide to contemporary decisions in real-time. Faced with an inoperable mandate, or perhaps one whose literal pursuit would be counter-productive in a given set of unforeseen conditions, monetary policy makers will understandably do what they think they have to and explain later.

The result is that broad central bank mandates in terms of noble concepts like "price stability" rarely have any traction on monetary policymaking in practice. Twenty years ago, I pointed out that while both the Deutsche Bundesbank and the Swiss National Bank abjured the inflationary policies of other central banks in the 1970s and early 1980s, they had meaningfully different legal mandates. Yes, the Bundesbank's mandate famously is for the pursuit of price stability above all, but the Swiss National Bank includes in its mandate "to ensure price stability and, in so doing, to take due account of economic developments," a view underscored by the SNB's reporting on many real and international factors—and still the two central banks had similar success in resisting inflationary pressures (Laubach and Posen 1997). Research shows that the pattern holds cross-sectionally, meaning there is no significant correlation between what a central bank's stated mandate or remit is, and the inflation outcomes they deliver (Posen (1999).

Central bank behavior during the recent financial crisis also reflected the irrelevance of too general mandates. Three of the four major central banks (Bank of England, European Central Bank, and Federal Reserve) pursued similar responses to the early stage of the crisis in 2008-09, and converged again in practice over the last year, with the fourth, the Bank of Japan, now catching up (Pisani-Ferry and Posen 2012). To the degree that the European Central Bank diverged from the others in 2010–11, it was in disregard of its set mandate—had it been following either the inflation or the monetary growth "pillars" that it is instructed to use as the guide for its policy, it would have eased further than it has.

An elected legislator might well ask, "What business do these unelected central bankers have ignoring their legal mandates?" and perhaps then to recommend stricter enforcement of rules on monetary policymaking. The regular re-emergence of proposals to put the United States back on the gold standard or the like are in part motivated by such a desire for more rules-based monetary regimes that can be enforced. Yet, the history of the gold standard is itself instructive about the reasons for why in practice such binding rules do not work.

Central banks found that over the course of economic fluctuations, of demographic and technological developments, and of shocks to the supply of gold and other commodities, strict adherence to the gold standard caused huge swings in the real economy, in asset prices and credit markets, and in trade flows. These proved unsustainable economically and politically, as well as simply destructive. As a result, economies would enter and exit the gold standard at various times, relaxing the rule when needed.[3] The gold standard did not enforce tough commitments by central banks—rather economies stuck with the gold standard when their central banks were tough. And toughness was not a virtue in and of itself under all circumstances. A parallel tale with parallel lessons can be told about the recurrent failure of commitments to fixed exchange rate pegs as a constraint on monetary policy.[4]

This is a major reason why the vast majority of independent central banks moved to a more or less formal inflation targeting regime over the past 20 years, often at the instigation of or in partnership with the elected officials who oversee them—so long as the government cannot force direct purchases of government debt by the central bank, or fire the central bank governor without cause, this does no harm to price stability.[5] It is a form of what I have termed disciplined discretion, whereby there is: a clear hierarchy of policy goals; those goals are practical being defined in terms of targets that monetary policy should be able to achieve on average over the medium-term (of 2-3 years); there is a transparent framework for evaluating their pursuit; and there is sufficient flexibility built in that the policymakers can spare the economy sharp swings from slavish pursuit of a rule over too short a time frame. There certainly is room for the re-evaluation of inflation targeting these days, especially in light of the crisis. But I believe that these aspects regarding the structure of the central bank's goal and the transparency of that goal's pursuit remain worth retaining for the Federal Reserve and other central banks, even if the specific terms or priorities are changed.

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[3] Bordo and Rockoff (1996), Eichengreen (1992), and Ahamed (2009)
[4] Except for very small open economies with a clearly stable dominant trading relationship to which to peg their currencies, such as Denmark and the euro or Hong Kong and the dollar, for whom such pegs may be the best alternative.
[5] Bernanke, et al (1999), Kuttner and Posen (2001)

The Responsibility of Central Banks to Stabilize Output

The question on mark at the end of the title of today's hearing implies some conflict or tradeoff between monetary policy closing the growth gap and promoting a sound dollar.[6] That question mark is itself highly questionable on any number of grounds. I will explain what several of those reasons are, and therefore why both are reasonable goals for the Federal Reserve to pursue—that is, why the Federal Reserve should keep its dual mandate.

The first reason to doubt such a conflict is simply to reject the notion that there is any evidence of a threat to the soundness of the US dollar. Inflation has been well below US historical averages for the last several years, and the dollar has largely been stable or appreciating against the other major currencies over that period. Bond markets, the prices of TIPS, forward contracts on Treasuries and on the dollar, consensus forecasts, and household surveys—the full arsenal of ways we have to measure expectations of inflation at least roughly—all give the same message of no inflation in sight.[7] One might assert (wrongly) that quantitative easing (QE) makes the bond market uninformative, but every other one of those measures of inflation expectations is safe against tainting by the Federal Reserve's action. In fact, it would be easy for investors and households to dump the dollar and other dollar-denominated assets if they were concerned about inflation, even if the Federal Reserve were to buy up every available Treasury note. Markets reveal no such worries or activity, and that changed not one iota when the FOMC announced QE3 or a threshold for unemployment.

The second is the usual co-movement of economic activity and inflation pressures. When the business cycle moves due to aggregate demand, which it usually does, trying to close the output gap and the stabilization of prices are mutually consistent. That is certainly the case today, when unemployment is well above even conservative estimates of the natural rate, the growth of GDP is well below even conservative estimates of US potential GDP growth, and the last several years were even further below trend. It is possible to make the case that there is a much weaker relationship than there used to be between movements in aggregate demand around the potential rate of growth and fluctuations in inflation (in the jargon, the Phillips Curve has

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[6] I commend the phrasing "closing the growth gap." Obviously, monetary policy that tries to drive growth well beyond a zero output gap, or unemployment well below the natural rate, and keep it there, will cause inflation and risk the dollar's soundness, as the Fed did in the 1970s. That is not a tradeoff, that is a misguided policy. So long as the intent of the central bank is to be consistent with a zero output gap (full employment), any mistakes made by overestimating the room to expand should be discernible and remediable. Therefore in my testimony, I leave this aside and focus on the output gap.

[7] With the gold bubble crashing due to the same kind of purely speculative swings that inflated its price in the first place, I hope that reasonable people can dismiss gold as any kind of useful indicator.

flattened).[8] So doing, however, simply reduces any possible tradeoff between a sound dollar and shrinking of the output gap, and puts the determinants of inflation solely in the monetary realm.

That leads to the third reason there is no conflict for monetary policy between the pursuit of a sound dollar and closure of an output gap: monetary, or more importantly, credit growth is disengaged from the real economy and from monetary policy. One major lesson of the recent financial crisis in the United States and Western Europe is that we have to beware of excess credit growth as a source of bubbles and busts. Excess credit growth is precisely that which is out of whack with either real GDP growth or narrow monetary aggregates (what the central bank can control rather than broad credit). We have seen central banks try to pop bubbles or stem credit booms with interest rate increases, and seen those efforts repeatedly fail.[9] In the other direction, we know that efforts to build up the recovery through quantitative easing have been limited in their ability to induce increased bank lending or credit growth (even though they have affected measures of confidence, some asset prices, and some interest rate spreads).

This is why discussion among central banks and finance ministries about how to prevent future booms and busts has focused on the creation of new 'macroprudential' tools—meaning policy instruments more direct than moving interest rates or central bank balance sheets that more directly influence the growth and allocation of credit. These tools may or may not work, that remains to be determined, but their development is a clear indication that monetary policy has little direct traction on credit and asset price booms. More to the point, this means that pursuit of real economic goals such as closing an output gap have no consistent effect, good or ill, on the development of credit booms and asset price misalignments. No matter how many people assert such a link, there is no support for it in the data.

One more issue raised has to do with what happens to price stability if continued QE proves to be insufficient to restore full employment. The notice of today's hearing, for example, says that "The Federal Reserve is taking unprecedented actions to attempt to drive employment gains…it's becoming increasingly clear there are limits to what monetary policy can achieve in the pursuit of the dual mandate." This statement strangely seems to imply that somehow the Federal Reserve trying to achieve full employment will cause a problem either because of the nature of the policies, i.e., large-scale asset purchases, which it is using in that pursuit, or just

[8] I would tend to counter that such flattening of the relationship is due to proximity of current inflation to zero, since wage movements are mostly bounded from below at zero, and the curve would steepen at more normal inflation rates with recovery.

[9] As discussed in Posen (2011), this visible pattern holds up to econometric scrutiny—in other words, loose monetary policy is not the cause of bubbles, no matter how many people wish to make the world simpler and less scary by believing that.

because those policies would be insufficient. I must, however, reject both halves of the hearing notice's characterization as confused and misleading at best.

Taking the second more obvious point first, the answer is that nothing happens to the dollar's soundness in that horrible situation of QE failing to be sufficient, and no other policy response being forthcoming. The tragic waste of American human resources, and the damage done to our citizens' lives through unemployment and lost income would continue to mount, but the credibility of price stability would be unaltered—unless the slow growth would induce deflation in itself or contraction in supply through, say, damage to the labor market. In that case, the right response would be to all the more aggressively pursue stimulative monetary policy. As I argued while serving on the Bank of England's Monetary Policy Committee in 2010, but with an eye towards Federal Reserve monetary policy as well:

> We will know we will have done enough with QE or other monetary stimulus only when we have clear indications that our policies are moving the desired variables...sufficiently and in the right direction on a sustained basis...[I]t is not enough for a central bank to say, "Look, expanded our balance sheet more than any time in history" or "we did things we never did before" and argue that "therefore we must have done a lot, if not too much."...that is backwards logic...like saying that "the fire must be out because we've already pumped more water than for any previous fire we've fought"...This is a worse fire than any of us have ever seen in our lifetimes,...and so we cannot judge our progress by how much effort or resources we have already put in (Posen 2010, 8).

Finally, what about this idea, implicit in the hearing notice for today, and explicit in a number of places, that the Federal Reserve is taking 'unprecedented actions' and by virtue of that characterization, the actions are dangerous? This view gets expressed sometimes in the form of concerns about the costs of QE or the risks of exit. I realize that many raise such concerns in good faith, including some current members of the FOMC, and there is an active attempt in various quarters to assess those hypothesized costs. To me, however, this is chasing phantoms when people for whatever reason refuse to believe the simple truths from the historical record of central banking.

There is nothing that unconventional about the monetary policy measures undertaken by central banks, including by the Federal Reserve, since 2008. For the preceding 200 or so years, central banks conducted policy solely through quantitative means, buying and selling a wide range of private- and public-sector assets. They took a lot of risk onto their balance sheets, and they made choices about which assets made the most sense to buy at any given time. It was only in the 1970s and later that central banks began to rely on their instrument interest rate to the exclusion of other procedures to conduct monetary policy. This shift came because there were some costs and distortions to conducting policy in that matter, but those were small inefficiencies.

The golden age of extreme price stability and sound dollar that some like to evoke as an ideal for today occurred while central banks were engaged in precisely this kind of quantitative easing and tightening behavior—or in the United States, before 1913, when ad hoc groups of private financiers responded to panics and fluctuations in liquidity through their purchases and sales of private assets, in the absence of the Federal Reserve. I defy anyone to come up with a relevant historical example, let alone a consistent statistical pattern in the data, of the mere fact of central banks engaging in large scale asset purchases leading to significant inflation or the erosion of financial markets.

Of course, there are examples of central banks causing high inflation by monetizing public debt. That is not, however, what is occurring today under QE, given the need for the Federal Reserve to purchase Treasuries in the secondary market, the freedom of investors to exit the Treasuries market and the dollar, the ongoing consolidation of the US structural deficit, and the verifiable commitment of the independent Federal Reserve to stop QE when either inflation or unemployment cross their publicly set thresholds. Neither public debt levels nor government borrowing costs are goals of current Federal Reserve policy, nor will they become its goals unless the Federal Reserve's independence is taken away by Congress.

Please do not use either unfounded concerns about QE, or legitimate constructive review of the Federal Reserve's goals, as an excuse to do that. And as you review the goals of US monetary policy, please affirm not only the dual mandate, but the more specific goal of closing the output gap. If anything, the resulting economic recovery would drive up interest rates on government debt issuance and reduce debt accumulation, so genuine fiscal conservatives should support the Federal Reserve's aggressive pursuit of its output stabilization goal.

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