Unconventional Monetary Policy, Normalization, and Reform

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Chair Huizenga, Ranking Member Moore, and members of the Subcommittee on Monetary Policy and Trade, thank you for inviting me to testify at this hearing on "Unconventional Monetary Policy."

Recent Policy

The Federal Reserve's move toward unconventional monetary policy can be traced back a dozen years to the so-called "too low for too long" period of 2003-2005. During this period the Fed held its policy interest rate—the federal funds rate—well below what was indicated by the experience of the previous two decades of good economic performance. During this 2003-2005 period the Fed also started giving forward guidance that its policy rate would remain very low for a "considerable period" and that it would be raised at only a "measured pace." These actions were a departure from the policy strategy that had worked well in the 1980s and 1990s.[1] Economists, historians, and biographers have been exploring the reasons why the deviation occurred.[2]

But regardless of the reasons, the results were not good. The excessively low rates along with promises that they would remain low brought on a risk-taking search for yield and excesses in the housing market. Along with a breakdown in the regulatory process, these policies were a key factor in the financial crisis and the Great Recession. And in a typical go-stop fashion the unnecessarily low rates in 2003-2005 brought unnecessarily high rates in 2007 and early 2008.

During the panic in the fall of 2008, the Fed did a good job in its lender of last resort capacity by providing liquidity to the financial markets and by cutting its policy interest rate.

But then Fed policy moved sharply in an unconventional direction. The Fed purchased large amounts of U.S Treasury and mortgage backed securities in 2009, financed by equally large increases in reserve balances, which enlarged the Fed's balance sheet. And long after the recession ended, these large-scale asset purchases continued and the Fed held its policy interest rate near zero when indicators used in the 1980s and 1990s suggested that higher rates were in order. The Fed also utilized forward guidance, but changed the methodology several times, which increased uncertainty.

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My research and that of others over the years shows that these policies were not effective, and may have been counterproductive.[3] Economic growth was consistently below the Fed's forecasts with the policies, and was much weaker than in earlier U.S. recoveries from deep recessions. Job growth has been insufficient to raise the percentage of the population that is working above pre-recession levels. There is a growing consensus that the extra low interest rates and unconventional monetary policy have reached diminishing or negative returns. Many have argued that these policies widen the income distribution, adversely affect savers, and increase the volatility of the dollar exchange rate. Experienced market participants have expressed concerns about bubbles, imbalances, and distortions caused by the policies. The unconventional policies have also raised public policy concerns about the Fed being transformed into a multipurpose institution, intervening in particular sectors and allocating credit, areas where Congress may have a role, but not a limited-purpose independent agency of government.

In many ways this recent period can be characterized as a deviation from the more rule-like, systematic, predictable, strategic and limited monetary policy that worked well in the 1980s and 1990s. Empirical research has shown that such deviations worsen performance in the U.S. and in other countries.[4]

Normalization

The policy implication of this experience is clear. Monetary policy should be normalized. The Fed should transition to a sound rules-based monetary policy like the one that worked in the past while recognizing that the economy and markets have evolved. This appears to be the intent of the Fed,[5] but normalization, or transition, is difficult in practice, and the pace has been slow and uncertain. With the policy interest rate still below appropriate levels, a key step is to begin to raise the policy rate gradually and strategically.

As part of the normalization process, the size of the Fed's balance sheet should be gradually reduced. For the reasons I gave when I testified before this committee last May,[6] reserve balances should be reduced to the size where the interest rate is market determined rather than administered by the Fed's setting the rate on excess reserves. The composition of the Fed's portfolio should focus on Treasury securities so that the Fed is not involved in private credit allocation. Given that the supply of reserves is now many times greater than demand, the Fed has no alternative but to pay interest on reserves during the normalization period. Careful monitoring and communicating with markets will be required to prevent instability.[7]

Reform

Normalization is easier if there is an understanding of the basic monetary strategy. This and recent experience point to monetary reform. A good reform is now part of the Fed Oversight Reform and Modernization Act. It would require the Fed to "describe the strategy or rule of the Federal Open Market Committee for the systematic quantitative adjustment" of its policy instruments. The Fed would choose its strategy, and could change it or deviate from it if circumstances called for a change, in which case the Fed would have to explain why. Some worry that, with this reform, the central bank would lose independence, but having and clearly articulating a strategy would improve independence. It is important to emphasize the word "strategy" as stated in the legislation. Though economists frequently use the word "rule," that term may convey the false idea that a rules-based monetary strategy must be purely mechanical.

There is precedent for this type of Congressional oversight. Legislation that appeared in the Federal Reserve Act from 1977 to 2000 required reporting the ranges of the monetary aggregates. The requirement was removed in 2000, creating a void which would be filled by the new legislation.

Recent empirical research shows that if this legislation had been in place in recent years, the Fed would have had to explain the deviations, which would have likely reduced their size.[8] Recent research also shows that economic performance would improve if the Fed was accountable about the rule for achieving goals as well as about the goals.[9] This legislation would provide a transparent connection between technical policy analysis at the Fed and actual policy decisions, a connection which is essential to sound monetary policy. For these reasons and others, a number of Nobel Prize winners, former Fed officials, and monetary experts have supported such legislation.[10]

Monetary normalization and reform have important implications for the international monetary system. Unconventional monetary policies with near zero policy rates have spread internationally as the Bank of Japan, the European Central Bank, and other central banks adopted similar policies.[11] Thus the international monetary system has deviated further from a sound rules-based system. This has increased the volatility of the dollar and other exchange rates, which in turn has caused governments to impose capital controls and intervene in exchange markets, frequently in non-transparent ways that raise suspicions of currency manipulation.

A key foundation of a transparent rules-based international monetary system is a rules-based policy in each country. Therefore, normalization and reform by the Fed contributes to international monetary reform. In my view, it would lead other central banks to move away from unconventional policies. International monetary reform will in turn benefit the United States.

In conclusion let me emphasize that monetary reform, tax reform, regulatory reform and budget reform often go together. They reinforce each other. All are crucial to a prosperous economy. The opportunity for monetary reform is better than it has been in years. The goals of insulating the Fed from political pressures, creating a more predictable-transparent-accountable policy, and better achieving economic stability and price stability appear to be widely held. The rationale behind pursuing several reforms together can be found in our *Blueprint for America*.[12] As I state in my essay in that volume: Sound rules-based monetary policy and good economic performance go hand in hand.

Thank you. I would be happy to answer your questions.

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