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NEAR-ZERO RATE, NEAR-ZERO EFFECT? IS "UNCONVENTIONAL" MONETARY POLICY REALLY WORKING?

HEARING

BEFORE THE

SUBCOMMITTEE ON

MONETARY POLICY AND TRADE

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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NEAR-ZERO RATE, NEAR-ZERO EFFECT? IS "UNCONVENTIONAL" MONETARY POLICY REALLY WORKING?

Tuesday, March 5, 2013

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON MONETARY
POLICY AND TRADE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. John Campbell [chairman of the subcommittee] presiding.

Members present: Representatives Campbell, Huizenga, Pearce, Posey, Grimm, Stutzman, Mulvaney, Pittenger, Cotton; Clay, Moore, Peters, Foster, Carney, Sewell, Kildee, and Murphy.

Also present: Representative Green.

Chairman CAMPBELL. The committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time.

The Chair now recognizes himself for 4 minutes for an opening statement.

I would like to first of all welcome our distinguished panel of witnesses.

Last week, Federal Reserve Chairman Bernanke testified in this room during the semiannual Humphrey-Hawkins testimony that he gives before Congress. He was asked many questions about quantitative easing, so-called "QE Forever," and the persistently low interest rates that the Fed is holding, and as to whether the benefits of this policy still outweighed the risks and negatives of this policy. Chairman Bernanke quite vigorously, I would say, defended the policy and defended that its benefits are still outweighing the risks in spite of some dissension in the Federal Open Market Committee itself, and certainly some disagreement here amongst members of this committee.

The purpose of this hearing today is to find out from you all, from some of the country's most distinguished economists, what your view is and whether you believe that the benefits of this policy equal the risks, exceed the risks, or outweigh the risks, and what, and if at any point in the future, when those different metrics might perhaps change to warrant the ending of QE Forever or a change in the interest rate environment in which we find ourselves. And so we will look forward to hearing all of your comments and thoughts on this issue which is pressing before us now.

And with that, I will recognize the ranking member of the subcommittee, Mr. Clay from Missouri, for 5 minutes for his opening statement.

Mr. CLAY. Thank you, Mr. Chairman, and thank you for conducting this hearing entitled, "Near-Zero Rate, Near-Zero Effect? Is 'Unconventional' Monetary Policy Really Working?"

And also, I want to thank the witnesses for appearing.

Mr. Chairman, I will begin with a short summary of why the economy is in its current state and what has led to the Federal Reserve System's use of quantitative easing policy.

The U.S. economy has taken a beating over the past 10 years. U.S. engagement in two unpaid wars, one in Iraq and a second in Afghanistan, has produced record amounts of government debt. Also during the past 10 years, bad actors in the housing and financial industries have contributed to the problems in the U.S. economy.

According to the Financial Crisis Inquiry report, a combination of excessive borrowing, risky investments, and a lack of transparency put the financial system on a collision course of self-destruction. The Full Employment and Balanced Growth Act of 1978, better known as the Humphrey-Hawkins Act, charges the Federal Reserve with a dual Band-Aid, both maintaining stable prices and full employment.

But during the height of the financial crisis, the Federal Reserve took major measures to pump more liquidity into the financial system. In September of 2007, the Federal Open Market Committee (FOMC) lowered the Federal fund rate from 5.25 percent to between 0 to .25 percent. Currently, the interest rate on overnight loans between banks has been close to zero since December of 2008.

To stimulate the economy, the Federal Reserve used two policies. The first is forward guidance regarding the Federal Open Market Committee's anticipated path for Federal fund's rate. According to Chairman Bernanke, "Since longer-term interest rates reflect market expectations for shorter-term rates over time, our guidance influenced longer-term rates and thus supports a stronger recovery."

The second type of policy tool employed by the FOMC is large-scale purchase of longer-term security, which, like forward guidance, is intended to support economic growth by putting downward pressure on longer-term interests rates. Also, the Federal Open Market Committee has indicated that it will continue purchases until it observes a substantial improvement in the outlook for the labor market in context of price stability.

According to the Federal Reserve, these monetary policies are supportive to the recovery while keeping inflation close to the Federal Open Market Committee's 2 percent objective. One example of this policy working is in the housing market.

Low long-term interest rates have helped spark recovery. With rising employment, family wealth, and the growth in the housing market, consumer sentiment and spending have been positive. Currently, the unemployment rate is 7.9 percent, down from a year ago of 8.3 percent and from 2 years ago of 9.2 percent.

In regards to inflation, the Federal Reserve remains confident that it has the tools necessary to tighten monetary policy when the

time comes to do so. Currently, inflation is subdued and the expectations appear well-based.

Again, thank you, Mr. Chairman. I look forward to the witnesses' comments.

Chairman CAMPBELL. The gentleman yields back his time. Thank you, Mr. Clay.

The vice chairman of the subcommittee, Mr. Huizenga, the gentleman from Michigan, is recognized for 3 minutes.

Mr. HUIZENGA. Thank you, Chairman Campbell and Ranking Member Clay, and thank you for bringing this distinguished panel to discuss, "Near-Zero Rate, Near-Zero Effect." Obviously, we know it is an important issue which has tremendous impact on our economy, and I am eager to hear your insight.

For too long, I believe, the government in many forms has looked upon itself as sort of the sole source to solve the social and economic ills that our country faces, and unfortunately, the Federal Reserve is no different. The Federal Reserve has continued to implement government-based solutions, whether it was prolonged reduction of near-zero interest rates, sort of, I would argue—excuse me—this artificial lowering of interest rates with quantitative easing, quantitative, QE2, QE3, QE Infinity, Operation Twist, and all these other things that has, frankly, only just led to prolonged high levels of unemployment, continued lack of consumer confidence, and frankly, erratic to no growth in the economy.

So what does the Federal Reserve decide to do in December of 2012? To continue purchasing mortgage-backed securities at a rate of $40 billion a month and $45 billion in long-term Treasury securities per month, so these measures must be working, right? I think that jury is very much out and the answer seems to be "no."

With our GDP stagnant and unemployment even higher than when President Obama took office in 2009, you don't see many economists predicting the economy taking off at anywhere near its historic rates and pace in the past.

So the answer is simple: The policies implemented and prolonged by the Federal Reserve have failed to deliver as advertised, and we need to correct that.

Now, when do these failed policies come to an end? The Federal Open Market Committee, FOMC, says they plan on keeping these zero rates, or near-zero rates, until at least sometime in 2015 with a target 6.5 percent unemployment rate. The ranking member brought up the Humphrey-Hawkins—this dual mandate; I am looking forward to having that conversation.

But I think the question is, at what cost? We need to explore that. And if not at what cost then, frankly, what benefit are we deriving from this?

And frankly, as a proponent of the free market and having a smarter, more efficient, more effective size of government and government put in place, let me point out that just one of the many problems with the Administration's policy, such as targeting of near-zero rates by the FOMC, it is an abomination, in my mind, that under this Administration, the new normal for unemployment has been around 8 percent.

We have seen it higher, and we have seen it just under that. But we know, frankly, that it is not a success at getting people back

to work; it is a Bureau of Labor and Statistics that the way they keep their counting of this—and unfortunately, we have seen people—unfortunately, people do not becoming employed, but because they are getting discouraged and leaving the workforce.

So thank you. I appreciate that and I look forward to learning how we are going to continue to have the private investment grow our economy.

Chairman CAMPBELL. Thank you.

The gentleman's time has expired.

I now recognize the gentleman from Illinois, Mr. Foster, for 3 minutes for an opening statement.

Mr. FOSTER. Thank you, Mr. Chairman.

And I have a couple of slides, if I could have the first one. There are two slides here that I think will be useful in framing the discussion of the recovery.

The first one is a comparison of the drop in household net worth during the Great Depression and during the downturn that we just went through. When people ask me to reduce to a single number where are we and where our economy is, I go to household net worth, which is simply the value of everything owned by families in America.

And so the top curve that you can see on there is the fractional drop in household net worth during the first Republican big financial collapse in 1929, where over the course of the next 5 years household net worth dropped by approximately 12 percent. And then when we transition to FDR's policies, over the course of the next nearly-a-decade, we have slowly recovered that.

If you contrast that to what we just went through in the last 15 months of the Bush Administration, where household net worth dropped by about a trillion dollars a month for the last 15 months, households in America lost a quarter of their net worth. So what we underwent was a financial drop that was twice as rapid and twice as deep as the onset of the Great Depression. It is remarkable, in that context, that we are not in a great depression today.

Fortunately, after roughly the beginning of 2009 we had a series of changes in policies. There was the big intervention by the Federal Reserve, probably 2 quarters before the V-shaped turnaround that you see not only in household net worth but in business profitability, the stock market, essentially every financial indicator you can look at.

This also happened, perhaps not as an accident, the quarter after we passed the stimulus—the so-called "failed stimulus." And so when you look at these, it is hard to actually look at this and conclude that there was not a positive benefit.

Interestingly, if you look at this in terms of just return on investment—the costs of the stimulus, and so on—it is less than—it is on the order of a trillion dollars. Household net worth has rebounded by more than 10 times that, and so you find a pretty high return on investment from that point of view.

If I could have the second slide, there are a lot of discussions about what would have happened if we had done nothing. Many of these get to be partisan. I have chosen here to put a bipartisan calculation of what would have happened if we had done nothing. This is by John McCain's financial advisor and also a Democratic econo-

mist who collaborated, and if you look at what would have happened with no intervention, they estimate that our economy would simply not have recovered, in terms of household net worth, and that they apportion roughly equal share of the credit for the recovery to the actions of the Federal Reserve and the stimulus.

So, I would like to bring up a lot of these points in the ongoing questioning. And thanks so much.

Chairman CAMPBELL. Thank you.

The gentleman's time has expired.

Mr. Grimm from New York is recognized for 1 minute for an opening statement.

Mr. GRIMM. Thank you, Mr. Chairman. I appreciate you calling this hearing, and I want to thank the witnesses for coming and testifying today.

I am very glad to see that we are devoting our very first hearing of this subcommittee to a very important, if not central, topic to the long-term health of U.S. capital markets, and indeed, the economy as a whole—namely, examining the long-term risks of the Fed's extraordinarily accommodative monetary policy over the last 5 years. And I personally am very concerned about the risks that the Fed's rapid balance sheet possesses to the stability of the Fed as well as its inability to possibly unwind its unprecedented asset purchases in a way that will not do significant damage to U.S. markets or, even worse, cause world markets to question the very soundness of the U.S. dollar.

So with that, I look forward to hearing what our witnesses have to say on these very important topics and I yield back the balance of my time. Thank you.

Chairman CAMPBELL. The gentleman yields back.

And for the final opening statement, the gentleman from Indiana, Mr. Stutzman, is recognized for 2 minutes.

Mr. STUTZMAN. Thank you, Mr. Chairman, for holding this very important hearing. I want to, of course, welcome the panel, as well, and I look forward to their comments.

Of course, as we are examining the effects of the Fed's unconventional approach to keeping interest rates so long is of great concern for me, and as for as long as they are. I am extremely concerned about how this market manipulation invariably distorts private investment decisions in the short and in the long term.

Furthermore, I look forward to discussing with our witnesses whether the Fed's market intervention is meeting its stated goal of creating economic growth and how it may, in fact, be doing just the opposite.

As a subcommittee, I believe we need to press the Fed to provide greater clarity on what the economic environment may need to look like in order for them to roll back some of these policies. Only then can we provide precise oversight.

Of most recent concern to me has been the Fed's decision to buy $85 billion a month until the unemployment rate falls below the largely arbitrary rate of 6.5 percent. To avoid some of the unconventional approaches discussed today, I remain committed to focusing the Fed exclusively on price stability by eliminating its dual mandate.

To do just that, I have introduced H.R. 492, the FFOCUS Act of 2013. I look forward to the witnesses' testimony and their expertise today.

Thank you, Mr. Chairman. I will yield back.

Chairman CAMPBELL. The gentleman yields back.

And so, we welcome our panel of distinguished witnesses.

Mr. David Malpass is president of Encima Global, LLC. Encima Global is an economic research and consulting firm serving institutional investors. He previously served as the chief economist at Bear Stearns, as Deputy Assistant Secretary of the Treasury, and as Deputy Assistant Secretary of State.

Welcome, Mr. Malpass.

Dr. Allan Meltzer is the Allan H. Meltzer professor of political economy at Carnegie Mellon University. He is also a visiting scholar at the American Enterprise Institute.

Dr. Meltzer chaired the International Financial Institution Advisory Commission, also known as the Meltzer Commission—you get your name on a lot of things—and was a founding member of the Shadow Open Market Committee. Dr. Meltzer served on the President's economic advisory policy board and on the Council of Economic Advisors.

Welcome, Dr. Meltzer.

Dr. John Taylor is the Mary and Robert Raymond professor of economics at Stanford University. He is also the director of the Stanford Introductory Economics Center and the former director—now a senior fellow—at the Stanford Institute for Economic Policy Research. Previously, Dr. Taylor served as Undersecretary of the Treasury for International Affairs and as a member of the President's Council of Economic Advisors.

I welcome my fellow Californian, Dr. Taylor.

And last but not least, Dr. Joseph Gagnon is senior fellow at the Peterson Institute for International Economics. Previously, he served as the Associate Director of Monetary Affairs at the Federal Reserve Board of Governors and as an economist at the U.S. Treasury Department.

Welcome, Dr. Gagnon.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. Without objection, each of your written statements will be made a part of the record after your oral remarks.

I suspect you all know the drill, but I will state it anyway. On your table, there is a light. It will start out green. When it turns yellow, you have a minute to sum up. When it turns red, please suspend.

Once each of you has finished presenting, each member of the committee will have 5 minutes to ask any or all of you questions.

With that, Mr. Malpass, you are now recognized for 5 minutes.

STATEMENT OF DAVID R. MALPASS, PRESIDENT, ENCIMA GLOBAL

Mr. MALPASS. Thank you very much.

Chairman Campbell, Congressman Clay, Congressman Grimm from New York, and members of the subcommittee, thank you for the invitation to testify on the effectiveness of current monetary policy. It is a great pleasure to join Allan Meltzer, John Taylor, and Joe Gagnon on this panel.

I think Federal Reserve policies have been weakening and distorting the economy rather than providing stimulus. The policies are hurting savers, distorting markets, and redistributing capital rather than increasing it.

The policies subsidize government, big corporations, big banks, foreign investment, and gold, none of which is a robust private sector job creator, and it comes at the expense of small and new businesses and other job-creating parts of the economy. The result is a departure from market-based capital allocation that is contractionary in the same way that price controls, income redistribution, and industrial policy are contractionary.

What I would like to do, Mr. Chairman, is walk through some of the graphs in my written testimony and mention them to you. I am on page one. What the Fed has done is keep interest rates very low and then substantially lengthen the duration of its assets by selling all of its Treasury bills.

So you see the graph at the bottom of one. The Fed is out of Treasury bills, and that used to be the mainstay of U.S. monetary policy.

The result of this extreme monetary policy experiment has been an actual decline in the GDP growth rates. Real growth has slowed from 2.4 percent in 2010 to 2 percent in 2011 and only 1.6 percent in 2012. So basically, the economy has been going backward at the time when the Fed is trying to stimulate it.

The Fed itself has had to lower its original growth projections. That is at the top of three. Each year, they have started with a projection and then had to reduce it because the results haven't turned out.

I think there is a problem in the transmission mechanism of quantitative easing to the economy. It isn't working under current circumstances of heavily regulated growth in private sector credit.

Private sector credit over the 3-year period of this Fed monetary policy, 2010 through 2012, is up only 1.6 percent, government debt is up 32 percent, and the Fed's liabilities are up 30 percent. So there is not a transmission from what the Fed is doing to what the private sector is feeling.

The Fed is setting an artificially low interest rate. What it hopes is that this will encourage consumer spending, but at the same time, it is undercutting the normal impetus of the economy to borrow during a recovery to lock in low rates before they go up.

The low-rate policy penalizes savers, it distorts capital allocation, and undermines critical interbank markets. The graph on page four shows you the paralysis going on in interbank markets, a point Professor Ron McKinnon has made.

The Fed is also pushing down yields for longer-term credit. That benefits a select group of favored borrowers, like the government,

at the expense of non-favored borrowers, such as new businesses, small businesses, and businesses that the government considers risky.

On page 5 of my testimony, I go through a number of other problems. The Fed is contracting the economy. In addition, the Fed has greatly expanded its role in the economy.

The Fed is asserting a legal authority to make unlimited large-scale asset purchases on its sole discretion when there is no systemic crisis. That has huge implications for the future, when each slowdown will cause the markets to believe the Fed might buy assets.

By using short-term credit, the Fed has created a maturity mismatch. The result of the Fed policy is a more powerful Fed and a risk to taxpayers when interest rates go up. The Fed now owes over $2 trillion in floating rate liabilities to commercial banks, which itself is a danger.

So in conclusion, Mr. Chairman—and I am going to flip to the end of my statement here—rather than quantitative easing providing stimulus, it is compounding the capital misallocation problem by trying to push more credit into corporate bonds. The Fed is operating as a speculator, borrowing short and lending long, while ignoring the conflict of interest this creates when it sets interest rates.

The best exit, in my view, would be for the government to adopt growth-oriented tax, spending, and regulatory policies in parallel with a new growth-oriented Fed resolve to downsize its role in capital allocation and commit to providing a strong and stable dollar. The combination would encourage private sector investment and hiring in the U.S. economy and would meet the Fed's mandate of maximizing employment while assuring price stability.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Malpass can be found on page 48 of the appendix.]

Chairman CAMPBELL. Thank you, Mr. Malpass.

Dr. Meltzer, you are recognized for 5 minutes.

STATEMENT OF ALLAN H. MELTZER, PROFESSOR OF POLITICAL ECONOMY, TEPPER SCHOOL OF BUSINESS, CARNEGIE MELLON UNIVERSITY

Mr. MELTZER. Mr. Chairman and members of the committee, our Constitution assigns responsibility for monetary policy to the Congress, that is, to you people. The Federal Reserve acts as your agent.

The Federal Reserve has expanded bank reserves more than 350 percent in the last few years. This is an enormous and unprecedented increase, and it continues.

In my opinion, no entity or agent in our government should have so much unrestrained authority. Current practice violates all our beliefs about checks and balances. It sets a terrible precedent that should be avoided and it achieves very limited benefits to our economy.

Many bankers applaud the current expansive policy. They profit from it because they can borrow from the Fed or in the money market at a quarter percent or less and lend to the Treasury at 1 per-

cent or more. They are able to improve their stock prices by paying dividends and increase their incomes by paying bonuses.

Does the Congress approve this transfer from taxpayers to the owners and managers of financial firms? I doubt seriously that you would vote for such a policy.

Chairman Bernanke describes the expansive policy as on balance of benefit to the economy. I disagree for several reasons.

First, we agree that the low interest rate policy encourages risk-taking, but among those taking their investment risk are retirees who cannot live on the income they receive currently from their usual source of investment, often bank certificates of deposit. Many are said to seek higher income by investing in emerging market bonds or domestic junk bonds.

We know from our history how this practice ends. It ends in losses and tears when interest rates rise, bond prices fall, and risky assets default. Or note what has happened to the prices of farmland, in part a result of the ethanol program that raised agricultural prices. We have seen this pattern of rising farmland prices many, many times. It ends in tears and heavy losses to those who invest in it.

These are examples of a general pattern of increased risk. Increasingly, investors do not want to hold money or low interest rate bonds. They shift into holding equities, raising equity prices, and taking the risk of holding high-yield bonds or claims on farmland, or other risky assets.

Federal Reserve policy is repeating the same mistake that brought us the great inflation of the 1970s. Then and now, the Federal Reserve expanded its balance sheet by financing the government's budget deficit. This time, the deficits are larger and the Fed's purchases are much, much larger.

And then, as now, the Fed tried to push unemployment rates down. Doing so, they ignored the lessons that Paul Volcker repeated here and elsewhere many, many times: expected inflation is the way to get low inflation.

We know from that experience and repeated experiences all over the world how highly expansive policy ends. It ends with inflation, followed by a big recession required to end the inflation by reducing money and credit growth and raising interest rates.

Ask yourselves, please, what you expect to happen to all the low interest rate bonds that the banks and others hold. Will they have enough equity reserves to absorb the losses that they will surely take or will there be another debt crisis?

The first Federal Reserve balance sheet expansion in 2008 prevented a breakdown of the payments system. That was the right thing to do at the time.

The next large balance sheet expansion, called QE2, added $600 billion to bank reserves and the Federal Reserve balance sheet. $500 billion went into bank excess reserves. That pays some interest to the bankers but does absolutely nothing for employment and economic activity.

Much of the remaining $100 billion went into reserves of foreign central banks. They bought the dollars to limit the depreciation of the dollar against their currency. Other central banks are now ex-

panding reserve growth rapidly. This prevents their currencies from appreciating.

We are now in the third round of QE expansion.

Let me close with this comment: The Federal Reserve will be 100 years old this year. Its history includes 2 multi-year periods during which inflation was low—the only two such periods in its history.

Real income and employment fluctuations were modest and recessions were mild. The two periods are 1923 to 1928 and 1985 to 2002. In both periods, the Federal Reserve generally followed a monetary rule. In 1923–1928, the rule was the gold-exchange standard; in 1985–2002 or 2003, the rule was Mr. Taylor's rule.

No rule will be perfect all the time, but the lesson you should draw is that following a rule gave much better results for the public and the country than policies based on forecasts and judgment. That is a lesson you should discuss and implement as you consider how to get off the path to crisis and improve on your responsibility for regulating the Federal Reserve and its monetary policy.

Thank you.

[The prepared statement of Dr. Meltzer can be found on page 62 of the appendix.]

Chairman CAMPBELL. Thank you, Dr. Meltzer.

Dr. Taylor, you are now recognized for 5 minutes.

STATEMENT OF JOHN B. TAYLOR, MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY, AND GEORGE P. SCHULTZ SENIOR FELLOW IN ECONOMICS, HOOVER INSTITUTION, STANFORD UNIVERSITY

Mr. TAYLOR. Thank you, Mr. Chairman, Ranking Member Clay, and other members of the subcommittee for inviting me to testify. And also, thank you very much for having this hearing on a very important topic.

You asked us to review monetary policy before, during, and after the financial crisis, and some of you in your opening remarks have already done that. I think to do that you need to go back almost a decade to the period of 2003, 2004, and 2005 when the Federal Reserve held interest rates very low by any historical standard, especially the previous 2 decades of the 1980s and 1990s. This caused the housing boom to be much worse than it otherwise was. It caused the search for yield; it caused risk-taking; and ultimately, the bust, which brought on the financial crisis in part.

When the financial crisis first showed up, the Fed misdiagnosed that. They provided liquidity facilities at a time where there were problems—credit problems—in the banking sector. This is how I think helped bring on the crisis part of the—the panic part of the crisis.

When the panic hit, the Fed did help stabilize things with their actions—in particular, the commercial paper market and the money market funds. That particular phase, October, November of 2008, was constructive.

However, when the emergency ended, the Fed continued with the emergency operations—quantitative easing and the other actions that have already been mentioned in this hearing.

My view is if you look at this whole period, it is characterized by unprecedented actions by the Fed. It has been unpredictable

movements of their instruments of policy, and I think it has caused harm.

If you think of the Fed's old criteria for performance, it looks very bad. Unemployment much higher than it needs to be during this period, and inflation stability no better than in the past. So by its own methods of comparing and evaluating itself, the Fed's performance has been very bad.

You can get some sense of this by thinking of what the Fed has forecast for this recovery. There are some charts in my testimony, similar to Mr. Malpass', which show that the recovery has been very disappointing for the Fed.

They thought growth in 2012 was going to be 4 percent on average. The most pessimistic forecasts were going to be 3.5 percent for 2012. It turned out to be about 1.5 percent.

Why the disappointing performance? Of course you can point to external factors, and you hear testimony along those lines from the Fed.

In my view, you can't really explain this by external factors. It really is related to the policy itself.

And what is so bad about the policy? Think about this. I have a chart in my testimony, if you can look, perhaps, on page 5, to show how unprecedented what we are doing is. This is not just normal monetary policy.

The Fed has expanded its balance sheet in ways we have never even seen before, and it is expected to continue that with its current Quantitative Easing Infinity, if you like. I think this caused enormous risks. It is a two-sided risk: one, inflation may pick up if the Fed can't undo this ease fast enough; and two, it is a downside. If they bring the funds back too quickly, that is a downturn. It is contractionary.

So there is this risk overhanging the financial system and the economy. I think that is a drag on growth. Firms are sitting on a lot of cash. Actually, some consumers are now sitting on a lot of cash. They don't want to go out and buy things with that uncertainty.

I think it is already a drag. This is not our future risk. This is a current risk.

When you talk about risks and benefits, or costs and benefits, the costs are now greater than the benefits and it is a great concern to me. It is one of the reasons unemployment remains high.

You also have the low interest rates, which reduce income for savers. And you have this adverse effect in the credit markets that has already been discussed by Mr. Malpass.

It is nice to be able to borrow at low interest rates. It is not so great to lend at low interest rates. It is not surprising that credit flows, especially to less-credit-worthy borrowers. It is low at this point in time. So I think it is basically that is a negative, and I—many other reasons why it is negative.

So on balance, to answer the questions raised in this hearing, I don't think the unconventional monetary policy is working. I am very concerned it is having perverse effects.

My hope is the economy will pick up this year, like everyone hopes, and that will give the Fed the opportunity to begin to back off some of these extraordinary measures. And if so, I think the

economy will improve, in which case the Fed can maybe have another reason to back off. I hope that is the case.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Taylor can be found on page 68 of the appendix.]

Chairman CAMPBELL. Thank you, Dr. Taylor.

And now, Dr. Gagnon, you are recognized for 5 minutes.

STATEMENT OF JOSEPH E. GAGNON, SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. GAGNON. Chairman Campbell, Ranking Member Clay, and members of the subcommittee, I would like to thank you for inviting me to explain why I believe America needs more expansionary monetary policy.

There are four major forces holding back our economic recovery: one, consumers are saving more to make up for losses in the value of their houses; two, banks are applying tighter-than-normal standards in lending; three, foreign governments continue to resist appreciation of their currencies, thus perpetuating a large U.S. trade deficit; and four, State and local governments initially, and now the Federal Government, have been cutting spending and raising taxes.

All of these forces reflect either greater saving or reduced borrowing, both of which hold down spending in the U.S. economy. Expansionary monetary policy is helping to offset these forces.

Low interest rates encourage consumption and investment, but total spending in the U.S. economy remains too low and most private sector forecasters expect employment to remain depressed and inflation to remain low for the next few years. This suggests strongly that the current stance of monetary policy is still too tight.

With the short-term interest rate essentially at zero, more expansionary monetary policy must work through unconventional channels. One element of unconventional monetary policy is to use newly printed money to purchase long-term assets.

Another element is to communicate to market participants that the future path of the short-term interest rate will be lower than they otherwise might expect. In these ways, the monetary authority can lower long-term rates of interest, which are not at the zero bound.

My research shows that the Fed's purchases of long-term bonds have lowered long-term interest rates not only on the bonds being purchased, but also on a broad range of long-term assets. Other researchers have confirmed this result.

I estimate that the 10-year Treasury yield and the 30-year mortgage rate are at least 1 percentage point lower than they would have been in the absence of the Fed's unconventional policies.

Most market participants believe that these policies have boosted stock prices and helped to keep the dollar from appreciating. There is no doubt that all of these financial developments encourage spending, including on consumption, investment, and exports, and thus support economic growth. I note in particular that refinancing long-term debts at lower interest rates goes a long way toward repairing household and corporate balance sheets that are holding back spending.

Chairman Bernanke has identified four costs or risks that are of greater concern with unconventional monetary policy than with conventional policy. In my view, none of these costs is close to being significant now or at any time in the foreseeable future.

The first cost of unconventional monetary policy is that the Fed could become the dominant buyer of long-term Treasury and agency securities, potentially reducing the liquidity and efficiency of the market for these assets. So far, this concern is purely hypothetical. But if it should ever materialize, there are strategies the Fed could adopt to prevent harm to financial markets and the economy.

The second cost is that the public might believe that it will be difficult for the Fed to tighten policy at the right time to prevent excessive inflation in the future. Such a fear might increase uncertainty and instability in financial markets.

The Fed has developed several tools to adjust policy that provide ample scope for future tightening. However, the real concern may be more with the Fed's willingness than with its ability.

Experience shows that inflation fears are highly sensitive to strong policy actions, or the lack thereof, in response to observed inflation. It is within the Fed's power to prevent this cost from occurring by adjusting its policy stance appropriately and visibly in response to unexpected deviations of inflation from its target.

The third cost is that low long-term yields may encourage risky behavior that threatens financial stability. Low long-term yields are not in and of themselves risky when they reflect expectations of the path of the short-term interest rate that are guided by the Fed and are supported by its holdings of long-term securities. Moreover, by boosting the economic recovery, increasing corporate profits, and decreasing the rate of bankruptcies, unconventional monetary policy reduces risks to the financial sector.

As Chairman Bernanke said last month, the current low level of interest rates reflects weakness in the economy. The sooner we can return to full employment, the sooner we will return to normal levels of interest rates. Premature tightening will only delay this return.

Indeed, in my view, if the Fed had been more aggressive in easing earlier, we might already have returned to normal rates of interest.

The fourth and final cost I will mention is the possibility that the Fed could incur financial losses on its enlarged balance sheet. This so-called "cost" is a complete red herring.

Since 2009, the Fed has passed the Treasury record profits on unconventional monetary policy and it is likely to continue to do so for a least a few more years. Any losses in the more distant future must be considered in tandem with the previous windfall profits. In addition, Treasury has benefited from higher tax revenues and from issuing debt at lower interest rates.

On balance, there is no doubt that unconventional monetary policy lowers the long-term burden of our national debt.

Thank you. This concludes my prepared remarks.

[The prepared statement of Dr. Gagnon can be found on page 44 of the appendix.]

Chairman CAMPBELL. Thank you, Dr. Gagnon.

I will now recognize myself for 5 minutes to ask questions.

My first question is for the three of you who are not fond of the current monetary policy: Last week, amongst the things that Chairman Bernanke said was, "monetary policy must remain accommodative if it is to support the recovery and reduce disinflationary risks." Clearly, the specter of a Japan-type scenario is hovering over the Fed currently, and wanting to avoid deflation. For the three of you, do any of you see that as a legitimate reason to keep monetary policy accommodative, as it is?

Mr. MALPASS. No.

Mr. TAYLOR. No.

Chairman CAMPBELL. Dr. Meltzer?

Mr. MELTZER. No.

Chairman CAMPBELL. No. One word. Would anyone like to elaborate on why the answer is no?

Mr. MELTZER. Yes. I think the evidence goes in the opposite direction. Since summer of this year—this last year—expected inflation, measured by the gap between nominal and real yields, which is not precise but at least indicative, has increased by about 50 basis points—that is a half a percentage point. It seems to be headed up, not down, indicating that the market is beginning to believe that inflation is a problem. And that is exacerbated by the uncertainty about when the Fed will get off its current policy.

There is a good deal of resistance to the policy within the Federal Reserve. Many of them have spoken out about it. One has dissented from it. So there is a growing internal opposition to the policy for many of the reasons that we have all elaborated here.

Chairman CAMPBELL. Mr. Malpass?

Mr. MALPASS. I am concerned that as the Fed is setting artificial interest rates, it causes the rest of the government, and in particular, the fiscal policy and regulatory policy, not to take the burden. The Fed is taking too much of the burden.

If there is a disinflationary risk, then a response to that would be to create productive growth. Tax reform, for example, would be a very important policy to stop a Japan-type loss decade.

Chairman CAMPBELL. Okay.

Dr. Taylor?

Mr. TAYLOR. I just don't see risk of deflation at all right now. I would add, though, that it is frequently mentioned by monetary policymakers as a reason, if you like, for excessively accommodative policies. And in particular, in the 2003, 2004, and 2005 period I mentioned, where I think rates were too low, given what has happened, and one of the reasons frequently mentioned at that time was concerns about deflation.

It is a very common thing that is said. I think it should be looked at with some skepticism. Of course, it can occur; it is not like it doesn't ever occur. But it seems to me it is not an issue right now.

Chairman CAMPBELL. Let me also ask the three of you—Mr. Malpass, you mentioned at the end of your remarks that instead of this monetary policy we should be doing tax reform, various fiscal matters in order to restore—continue or—or accelerate economic growth. But that is fiscal policy, that is not monetary policy.

So now, taking fiscal policy aside and assuming for the moment that it is what it is, or it will be what it will be, and so you have only monetary policy—you are at the Fed now and so you only have

that trigger to pull, what should we do? What would the correct monetary policy be, absent the one that we have now?

Mr. MALPASS. My thought is to stop digging the hole deeper. The Fed is taking on more and more burden and giving people longer- and longer-term promises of zero rates. I think those should be walked back, and that would allow the economy to begin functioning more naturally and the capital allocation process to resume.

Chairman CAMPBELL. Dr. Meltzer?

Mr. MELTZER. I think you need a rule. I think you need a rule for two reasons—two major reasons. Many reasons, but two major reasons. One is, you need to exercise greater discipline over the Fed. No one, as I said in my testimony, should have the authority to increase its balance sheet as much as it does without any congressional oversight. So you need a rule that you can enforce on the committee on the Fed.

The second is, you need to give—

Chairman CAMPBELL. Something like the Taylor Rule, perhaps?

Mr. MELTZER. You need to give—the Taylor Rule would be fine. No rule would be perfect. But a rule will discipline the Fed and it will give information to the public about the long-range consequences of monetary policy. Too much of what they do is aimed at the very near term.

Chairman CAMPBELL. Dr. Taylor, 10 seconds?

Mr. TAYLOR. I think we learned so much about what worked in monetary policy in the 1980s and 1990s until recently, so go back to that general style of policy as soon as possible.

Chairman CAMPBELL. Thank you.

My time has expired, so I will recognize the ranking member, the gentleman from Missouri, Mr. Clay, for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman.

Let me start with Dr. Gagnon. Tell me, critics of quantitative easing have argued that it is incompatible with the Fed's price stability mandate. However, in discussing quantitative easing the Fed has consistently noted that the program is designed to promote a stronger pace of economic growth and to ensure that inflation over time is at levels consistent with the Fed's mandate.

To what extent has quantitative easing been effective in keeping inflation in the desired range of 2 to 2.5 percent, and is there any evidence whatsoever that the dual mandate creates a perverse inflation merit base?

Mr. GAGNON. Thank you. I think the dual mandate is in some sense unavoidable. If you look around the world, whether central banks have a dual mandate or not, they almost uniformly act as if they do.

So in the interest of transparency, I think we should keep a dual mandate. We can't pretend that monetary policy doesn't affect both inflation and the real economy, employment and activity, so why not be open about it?

I think the Fed's—we did see a decline in inflation in the early years after the recession, and the Fed's easy policy, I believe, has been helpful in preventing that from going lower. One thing we have learned, though, out of this is that it is very hard to make prices fall.

Deflation doesn't come easy. We see that in Japan. And so I don't fear deflation right now. But we would have come closer to it if we had not had this easy policy.

Mr. CLAY. According to Dr. Taylor, the Fed's current monetary policies perversely decrease aggregate demand and increase unemployment while they repress the classic signaling and incentive effects of the price system. Do you agree that current monetary policies increase unemployment?

Mr. GAGNON. No, I do not. I think a good analogy for where the economy is right now, we often hear the story that monetary policy is like driving a car, only with no windshield and only a rearview mirror. You can just see a little bit of where you have just been, so you don't know what is going on.

I think we have hit a hill that may be steeper than any of us have seen in our lifetimes and we didn't know it. When you hit a hill when you are driving, you step on the accelerator, and you hope that you will go faster. But if you are starting up a steep hill, you might go slower.

Then the question becomes, what is wrong? Some people think that perhaps the car is broken down, perhaps the brake pedal and the accelerator have mixed up. Maybe if we press on the brake, we will go faster.

I don't think so. I think if we press harder on the accelerator, we will go faster; we are just facing a very steep hill.

Mr. CLAY. Anyone can take a stab at this one. What is the tipping point? What tips us that inflation is about to kick in?

And I will start with you, Dr. Gagnon. What are good indicators?

Mr. GAGNON. I think you would see—if you see broad and—measures of prices, sort of—not just a few extreme ones, like commodities, but broad measures, and especially in the labor market, if you start seeing large pay increases that were well ahead of productivity, that would be an early indicator that maybe this is becoming a problem. I don't see any evidence of that.

Mr. MELTZER. May I answer that?

Mr. CLAY. Each one of you can. I am trying to get to everybody. Go ahead.

Mr. MELTZER. Asset prices start to rise, money starts—people start to get out of money and bonds and shift into asset prices. Farmland prices start to rise. All the things that we see happening now are happening. The Fed missed that completely in the run up to the 2007–2008 fiasco because they don't pay much attention to asset prices, but they should.

Mr. CLAY. But does that include housing prices, too? They are starting to rise. Is that a signal of a recovering housing market or inflation coming?

Mr. MELTZER. Part of that is people buying houses on speculation. That is a sign that they expect prices of houses to rise. When prices of houses rise, don't you think rents are going to rise?

Mr. CLAY. That is not what the housing market is indicating to us now, is that this is the spring—spring is coming and people are starting to buy houses.

Chairman CAMPBELL. The gentleman's time has expired, so maybe someone else can follow up with that.

The gentleman from Michigan, the vice chairman of the subcommittee, Mr. Huizenga, is recognized for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman.

I appreciate you all being here today, and I'm sorry I had to step out for a quick radio call-in.

But, Mr. Malpass, you hit on something that I exactly used those words, artificially low rates, and it seems to me—and I don't want to put words in your mouth; I want a few of you to address this—but you are saying that these artificially low interest rates have not spurned economic activity as was hoped, correct?

Mr. MALPASS. That is right.

Mr. HUIZENGA. Okay. So what you are saying is if I am going to go buy a house, maybe the make it and break it isn't whether it is a 3.75 percent interest rate on my 30-year mortgage versus a 4 percent 30-year mortgage, or maybe, like my family's circumstance, we own a construction company in Michigan. You may have noticed that it has been a bit soft in the last few years.

I have a 12-year-old loader that I need to replace. It doesn't matter what the interest rate is because banks and, frankly, their regulators, are coming in saying, "We don't want construction equipment on your books." So who is going to give me that loan, because I haven't had a whole lot of time here to ramp up my savings to try to get enough cash together to go purchase that?

So I just wanted you to maybe talk a little bit about these artificially low interest rates.

And then the other thing, this really struck me as—the best exit, as you were talking about, is not just spending, but tax as well as regulatory policies. And it seems to me that those tax and regulatory policies—and I tried bringing this up with Chairman Bernanke last week at our hearing as well—has a huge amount of impact. Isn't that true?

Mr. MALPASS. Yes. Thank you, sir.

The Fed had the rates at zero for more than 4 years, and yet the recovery has been very subpar. The reason for that is because it is an artificially low rate.

Economics is very, very clear. When you set the price of something too low, you end up with shortages, and that is what you were describing in Michigan.

The big corporations and the government can get lots and lots of loans, but smaller businesses can't. That is a natural part of a price-fixing mechanism, which is what the Fed has been doing.

What you are describing is logical, that some parts of the economy are feeling this asset price inflation that Dr. Meltzer has described, and then other parts are not feeling the growth at all. That is because the capital is getting channeled and redistributed.

Mr. HUIZENGA. I can tell you, the housing prices in Michigan have bottomed. Raw land has bottomed. There is only one way to go but up, and people are literally sitting there saying, "I don't know if I could buy a home for cheaper than what I could build a home right now." And, lots that used to go for $75,000 or $100,000 are going for $25,000, maybe $30,000.

Dr. Meltzer, I do want to—on page 3 you talked a little bit about being in the third round of quantitative easing, and I thought you put it beautifully here. Why does the chairman claim greater bene-

fits than costs? Mainly, he makes the mistakes of looking only at interest rates, never mentioning what happens to growth of credit and money.

I am not a Ph.D. economist like you all, all right? But I did take a few economics classes, and I recall one of my first economics classes discussed the law of diminishing returns. It seems to me that is exactly what we are talking about right here and what we are going after. "Well, if maybe we just lower it a little bit more then we will get this greater cost, or maybe if we spend or stimulate the economy by spending twice as much we will get double the amount of activity."

Could you address that a little bit?

Mr. MELTZER. Yes. The only time—I have written the Fed's history, so I read most of their minutes from the 1920s to the 1980s. There is hardly ever a time when they say the following: "If we do this today, where will we be a year, or 2 years from now?" That is a question because we know that monetary policy doesn't work quickly.

The one time that they actually discussed the policy that would relate to your question was at the end of the Volcker disinflation. They had very high real interest rates. Real interest rates during that whole expansion were 5 to 7 percent after allowing for inflation, and money growth was very high.

And they discussed the question, which one of these things will dominate? Will we have a slow recovery because of the high real interest rate or a fast recovery because of the fast money growth and the fast growth of credit?

The answer is pretty obvious now, in hindsight. In 1983, the economy grew at gangbuster rates despite the high real interest rates.

That is, the interest rate matters, but so does the money and credit growth. And we are not getting the money and credit growth because most of the reserves that the Fed are creating are going to finance the government's deficit and sitting in excess reserves.

Chairman CAMPBELL. The gentleman's time has expired.

And you should know, Mr. Huizenga, that Dr. Meltzer and I both have economics degrees from UCLA. Now, his happens to be a master's and a Ph.D., and mine is a bachelor's, but I think that is an insignificant distinction.

Mr. HUIZENGA. I didn't want to point out anything beyond that, Mr. Chairman—

Chairman CAMPBELL. Oh, yes. Okay. I just thought that was an interesting point—

Mr. HUIZENGA. I will note that he is on that side of the table, though.

Chairman CAMPBELL. So no, we are basically the same. Yes, okay.

And now, I recognize the gentlelady from Wisconsin, Ms. Moore, for 5 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman.

And I want to thank the witnesses for appearing.

It is hard to dispute the expertise of this panel with respect to the Fed policy sort of forcing the investor to chase the highest yield, and that might have a negative impact on bonds and so

forth. But in an effort just to defend the Chair a little bit, he is trying to create some kind of economic activity by lowering the interest rates, maybe trying to increase some risk-taking so that there is some economic activity.

I will start with Dr. Gagnon. With those stipulations, Chairman Bernanke also said that he thought a more direct way of helping our economy is to deal with people who don't have a lot of bonds—maybe those mothers who need Women, Infant, and Children programs, or those seniors who need low-income heating assistance, or senior meals, that if we were to stop the sequesters and this cut—cutting—being concerned about the debt on a short-term basis instead of a more long-term strategy, that might be more stimulative to the economy than just continuing to do the quantitative easing.

But to the extent that we keep cutting and cutting and cutting, the Fed is doing the only thing that it can do.

Mr. Gagnon, would you respond to that?

Mr. GAGNON. Yes, certainly. And I think Chairman Bernanke himself even would support what you just said. I think this is not a good time for further cuts right now. We had a big—we had a tax increase this year. That is, in my view, more than enough for 1 year.

We don't need any further spending cuts this year. I would stretch them out in the out years. It is certainly holding back growth in the economy.

Ms. MOORE. Okay.

Dr. Taylor, I wanted to ask you about your economic models that produced the connection between interest rates and the housing boom, and I was wondering if you had any models that demonstrate that the Fed's QE could just briefly in 20 seconds just sort of outline the models that you have that the Fed policy is hurting the economy.

Mr. TAYLOR. The study of quantitative easing that I did was right after it began in 2009. It focused on the mortgage-backed securities purchases. I looked at the—tried to control for other things that affect risk and found that did not reduce the mortgage interest rates.

That was my main, own research, so it is quite contradictory to what Mr. Gagnon has stated. That model is well-documented and published.

The other model used to show that the rates were too low in 2003, 2004, and 2005 was a different model that was simulated, and I think that has been proven to be pretty accurate.

Ms. MOORE. Okay. Thank you, Dr. Taylor.

I guess the question I would like to ask the other two gentleman in my remaining time is, with respect to, again, the sequestration and our worry that we are going to have interest rates which are too low, don't you think it would be very harmful to the economy to just immediately raise interest rates? Aren't we concerned about inflation with respect to the Fed suddenly pulling back from these low interest rates?

Dr. Meltzer?

Mr. MELTZER. Yes. I don't think that we want to go through a draconian policy of suddenly raising the interest rate a lot. We

want to get on a path toward a long-term, stable policy. We have to send people a message—

Ms. MOORE. Do you think that stopping dramatic cuts and taking huge sums of money out of the economy immediately is part of that?

Mr. MELTZER. The money isn't going into the economy. Most of it is going into bank—

Ms. MOORE. I am talking about with respect to consumer spending, like the sequester.

Mr. MELTZER. There isn't much financing of consumer spending coming out of the QEs.

Ms. MOORE. I understand that.

Mr. MELTZER. I don't question—let me just say, I do not question Chairman Bernanke's intentions. I question his results. His results are not nearly consistent with his stated intentions.

We are not getting growth of money and credit at a very rapid rate that would stimulate consumption or investment. And we are not getting a great deal of investment. We need investment for growth. We need a long-term policy. We are not getting that.

Chairman CAMPBELL. The gentlelady's time has expired.

But I must say, Ms. Moore, when—at one point there where you said you wanted to defend the Chair, for a brief instant I thought you were defending me rather than—

Ms. MOORE. Oh, I always defend you.

Chairman CAMPBELL. Oh, okay. All right, rather than Chairman Bernanke. But then you went on about Chairman Bernanke, so I am a little hurt. But I will get over it. I will get over it.

Now, I would like to recognize for 5 minutes the gentleman from South Carolina, Mr. Mulvaney.

Mr. MULVANEY. Thank you, Mr. Chairman.

Dr. Gagnon, I would like to start with you. You mentioned in your written testimony a couple of the costs of unconventional policy. I guess I could ask questions about each one, but I will go through them very quickly because I want to talk about the last one more specifically.

The first one, you say that the risk is that the Federal Reserve would become the dominant buyer and holder of long-term Treasuries. I think the Treasury bought about 77 percent of all the debt last year. I wonder what more it would take for them to become the dominant buyer. But again, that is not my question.

The second risk you discuss is that the public might believe it will be difficult for the Federal Reserve to tighten policy, thus leading to worry of inflation. I would suggest to you that some members of the Federal Reserve Board, sir, are doing exactly the opposite, which is that I think late last year the head of the Minneapolis Fed said that he would be willing to go above the 2 percent range to 2.5 percent. San Francisco Fed said they would go to 2.5 percent. And the head of the Chicago Fed said he would like to go to 3 percent on inflation. So I would suggest to you that those risks are real and that certain members of the Federal Reserve are doing the exact opposite of what you would suggest.

Third, you talk about encouraging risky behavior. The long-term yields being at a low rate for a long period of time would encourage risky behavior. And I was stunned here a little bit ago to see you

go into the effects of systemically important institutions and how risk managers could handle this.

But I think Dr. Meltzer made the excellent point that I am not really concerned about the important financial institutions as much as I am about the individuals. And it is the retirees and the folks living on fixed incomes who are really the ones we are encouraging to engage in risky behavior. And as Dr. Meltzer correctly pointed out, I think that ends in no good.

But again, with 5 minutes, I only get one question to ask.

So I want to talk about the last one which you talk about, which you describe as a red herring, which is the losses that the financial, that the Federal Reserve could incur on its enlarged balance sheet. And you go on to say that the Federal Reserve is—the term, I guess, is remittance—giving a lot of money back to the Treasury.

Elsewhere in your testimony, you said you thought that the current interventions policies probably depress interest rates by about 1 percent. I ran the math on that in the back of my head and on the tablet in front of me, and that tells me that if the Federal Reserve gets out of this business tomorrow, interest rates on a 10-year would go up by 1 percent. If I translate that into a capital loss on the balance sheet of the Federal Reserve, which is roughly $3 trillion—I know it is not all in 10 years but it makes the math easier—roughly you are talking about a 10 percent loss, $300 billion worth of capital loss in an instant, which, I would suggest to you, exceeds the total remittances that the Federal Reserve has given to the Treasury since 2009.

They gave $90 billion, roughly, last year, according to Chairman Bernanke's testimony last week. They have given about $290 billion since 2009. That doesn't include the losses that they would incur on paying additional interest on the reserves they hold from the financial institutions.

So I want you to tell me why this is a red herring. A 1 percent increase in interest rates would lead to several hundreds of billions of dollars of capital losses and operating losses, perhaps, at the Federal Reserve. So tell me why that is a red herring.

Mr. GAGNON. Sure. The Federal Reserve has already given extra profits, above normal profits, that are almost equal to the costs of $300 billion that you mentioned, and in the next couple of years, it will have done so. So you will be subtracting $300 billion from excess profits that exceeded $300 billion—

Mr. MULVANEY. But that is only 1 percent. Let's think about what happens if we go back at the historical average of 5.5 percent. That is 450 basis points, or 400 basis points over where we are now.

Mr. GAGNON. It is possible there could be larger losses than $300 billion, that is correct. But again, profits will be quite a bit higher than that going in.

Also, what you are not including is the gains to the Treasury. The Treasury will have issued long-term Treasury bonds yielding much less, and those gains are locked in forever, or for the life of the bond, 10 to 30 years. That is money the Treasury would have had to pay in interest it will not, and that is hundreds of billions, too.

And on top of that, by getting the economy growing faster, and more spending, and a bit more inflation than otherwise, tax revenues will be higher. And that is paying down the debt, too.

So it all adds up. If you add all the pieces together, there is no way it does not lower the burden of our debt.

Mr. MULVANEY. So several hundred billion dollars, potentially a trillion dollars of capital losses, an additional billions of dollars in operating losses is something we shouldn't be concerned with because it will be, what, made up someplace else?

Mr. GAGNON. Exactly.

Mr. MULVANEY. Thank you, Dr. Gagnon.

Chairman CAMPBELL. The gentleman yields back.

Mr. Foster of Illinois is recognized for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman.

In Dr. Taylor's testimony, he emphasized the role of monetary policy in the early 2000s as a real driver of the housing bubble, presumably. But there are really three legs of policy. There is monetary, fiscal, and regulatory policy.

And I was wondering how you would apportion the credit or blame for the financial collapse or the bubble that led to the financial collapse between those three legs of policy. What fraction of it was due to each?

Mr. TAYLOR. I think the regulatory policy is maybe equivalent and equal to the monetary policy measures. It is very hard to quantify, to be sure.

But there you had, I think, a situation where certain entities who should have been not taking the risks they took, took the risks, and they were overlooked by regulators. Fannie Mae and Freddie Mac are an example, but in addition, a lot of the large commercial banks were certainly, in retrospect, taking risks that the Federal Reserve should have been watching for—the New York Fed, in this particular case, mainly.

So I think that is very high. It raises questions about the way that regulators enforced regulations, and that should be examined. It is not that you need more regulations; just means the ones on the book need to be taken seriously.

So I would put that up there along with the monetary policy. It is actually part of monetary policy.

Mr. FOSTER. So for example, the Fed's apparent refusal to enforce mortgage origination standards nationwide, which was, I think, given to them in 1994, sometime in there, and then despite repeated urging, then-Chairman Greenspan decided not to enforce that. You view that as a significant driver of the housing bubble?

Mr. TAYLOR. I would focus more on the risks that the banks were taking and holding as securities.

Mr. FOSTER. And then the other—the third leg of the triad is fiscal policy, where, of course, during the Republican years it went from basically a surplus to a trillion dollar structural deficit by the time President Bush left office. How would you mix that in, in terms of—

Mr. TAYLOR. By 2007, the Federal deficit was a little over 1 percent of GDP, and Federal spending had increased to 19.7 percent of GDP. And remember, in the year 2000, Federal spending was only—

Mr. FOSTER. But by 2008, when the bubble popped, there was a huge structural deficit because of all the costs that the government incurs when household net worth drops by $17 trillion.

Mr. TAYLOR. I would say that in the year 2007, before—

Mr. FOSTER. During the peak of the bubble. Right.

Mr. TAYLOR. —near the end of that year, during that year you could argue we were close to full employment and the deficit was a little over 1 percent of GDP, so that would be one measure, maybe somewhat larger than one measure of the structural deficit. But I think it is hard for me to see why that is the cause of the crisis, because—obviously, we would like to have a smaller deficit, but you can see that 1 percent is—hard to see why that would drive things.

Mr. FOSTER. I would like to talk quickly about the rules-based—Dr. Meltzer has emphasized the need for rules-based things, and particularly when you look at the housing bubble, which I view as the main driver—that along with the buildup of leverage in the financial system. There have been, at the American Enterprise Institute, as Dr. Meltzer may be aware, a panel of discussions and there will be a workshop this summer on countercyclical loan-to-value requirements for real estate, which other countries very successfully use to fight bubbles. Israel, for example, and other countries have squelched housing bubbles by turning up the downpayment requirement at times when they see bubbles developing.

There are rules-based approaches to this, the simplest being, for example, just a requirement that federally-backed mortgages cannot exceed the value the property had 3 years ago, being one simple example of one. And I was wondering if you could comment, maybe starting with Dr. Meltzer, on the feasibility and desirability of having countercyclical elements in the real estate market, and particularly ones that might protect for the federally-backed section of the real estate market, ones that might protect the taxpayer from the sort of damage they have seen in the collapse of the bubble.

Mr. MELTZER. Most countries have housing policies—housing without having as many subsidies as we have, and one of the problems—you mentioned regulatory policy. Regulatory policy was really a big factor in this crisis.

You had a system in which people like Angelo Mozilo, a well-known name, could make tens of millions of dollars by just shoveling bad mortgages onto Fannie Mae and the regulators did nothing about that except to encourage it. That is a terrible problem with regulation. Regulation gets captured, it gets circumvented, it breeds crony capitalism.

I am convinced that the only regulations which are really effective are regulations which change the incentives of the people you regulate. You want them to want what you want. You don't want to give them rules which tell them, "Be good," because they will circumvent them and ignore them.

Chairman CAMPBELL. The gentleman's time has expired.

And without objection—we have three more questioners here in this round—we will have a second round of questioning, but I will now move to the gentleman from North Carolina, Mr. Pittenger, and he is recognized for 5 minutes.

Mr. PITTENGER. Thank you, Mr. Chairman.

Thank you, gentlemen, for your assistance to this committee and your service to our country.

I would like to Dr Meltzer, the central planning model that this Administration has pursued, albeit through the Fed's expansionary monetary policy, has clearly not achieved their desired objectives, trying to find 6 percent unemployment and 4 percent economic growth. But more importantly, of concern to me is the unprecedented legal authority that has been advanced by the Fed.

In light of that, we recognize that the Fed is an independent central bank. However, are there any reforms you think that Congress should consider as it pursues its relationship with the Fed and trying to improve the accountability of the Fed?

Mr. MELTZER. Yes. Absolutely.

I believe the Congress has an obligation, in order to fulfill its requirement under the Constitution, to adopt a rule which restricts what the Federal Reserve can do without your permission. I think the Taylor Rule is an acceptable rule. A price stability rule would be a fine rule.

No rule will be perfect under all circumstances, so the rule has to say something about what you do when you don't think it is appropriate.

Years ago, I made a proposal to the Reserve Bank of New Zealand. I said, adopt a target. If you hit the target, fine. If you don't hit the target, you send two messages. One says, "Here is our resignation; we failed. And here is our explanation of why we failed." And the authorities have a right to choose among those explanations because there are legitimate reasons why you may miss.

Now, 20 countries have adopted something which improves on that rule by adding price stability. The United States has not.

It is time that we adopt a rule for monetary policy to assure yourself that you can say to the Federal Reserve when they appear here, "Look, you told us that in this year, 2 years from when you made—no, 3 years from when you made the forecast, that we would have this outflow, and this inflation, and you haven't done it. Explain to us why you haven't done it." That puts the Congress back into the game where it belongs.

Mr. PITTENGER. Thank you.

Mr. Malpass, Chairman Bernanke testified before us last week that there are not any asset bubbles forming as a result of his exceptionally accommodating monetary policy. Does this coincide with what you and your clients are seeing in asset markets today?

Mr. MALPASS. Thank you, sir. Today, the stock market hit a new all-time high, so there is a levitation going on in equity prices. We have also seen high-yield markets levitate. The yields fall, the price goes up, and the Fed has been explicit in its policy in stating that it is trying to cause asset prices to go up.

My concern is that tends to be a narrow set of financial assets and not connected to job growth and small business growth that would be more desirable in the economy as a whole. Dr. Meltzer mentioned farmland, and the Federal Reserve Board itself has talked about asset price bubbles in farmland and also in the high-yield market. A recent statement by a Fed official talked about it

being a tip of the iceberg in terms of what banks are now holding on their balance sheet in terms of appreciated assets.

May I come back to your previous point very briefly?

Mr. PITTENGER. Sure.

Mr. MALPASS. Sir, there is also the question of whether you want to leave the Fed with unrestricted asset-buying authority, which is the implication of the current policy of the Fed. Apart from our current crisis, 20 years from now I am worried that the markets and the economy will look to the Fed to keep buying things and they will expand their desire for the Fed to buy municipal bonds, or other assets. I am worried about that open-ended authority.

Mr. PITTENGER. Slippery slope. Never ends. Thank you very much.

Chairman CAMPBELL. The gentleman's time has expired.

The gentleman from Delaware, Mr. Carney, is now recognized for 5 minutes.

Mr. CARNEY. Thank you very much, Mr. Chairman.

And I thank the panelists for being here.

Dr. Taylor, it is good to see you again. We met out in California in your office.

Very interesting, if not a little esoteric, conversation today for me. I am a first-time member of this subcommittee, certainly no expert. I don't have the kind of economics training that you all do, so I appreciate your expertise.

I have just a few questions, if I may. One is about the dual mandate of Humphrey-Hawkins—price stability and full employment. Do each of you think that is an appropriate mandate for the Fed, and if not, I think you have had—we have had some discussion about maybe how it would be different.

But why don't we start with Mr. Malpass?

Mr. MALPASS. If I may defer to Dr. Meltzer or Dr. Taylor—

Mr. CARNEY. Sure. Please do.

Mr. MELTZER. I find it acceptable because it is politically desirable, and it is important that what we do is acceptable to the public. I would prefer a price stability target, because that is what the Fed is really capable of doing. It is capable of enforcing price stability, and that is a very desirable thing.

As Paul Volcker testified many, many times before this committee and elsewhere, the way to get low unemployment is to get low expected inflation.

Mr. CARNEY. Is it your view that has become maybe the primary focus of the Fed, in terms of price—

Mr. MELTZER. One of the things I object to in the way the Fed operates is it concentrates on one of the goals in the dual mandate until the other one gets out of line and then it concentrates on that. That puts additional variability into the economy.

Professor Taylor has measured variability several times. Chairman Bernanke, before he was a policymaker, when he was an academic, measured variability. We could reduce the variability in the economy, and that would be good, if we didn't shift from looking at—worrying about unemployment until inflation rises, and then worrying about inflation and raise the unemployment, and worrying about unemployment and so—

Mr. CARNEY. Dr. Taylor, do you have—my time is ticking—

Mr. MELTZER. That is a bad bicycle to ride.

Mr. TAYLOR. Just briefly, I am concerned about the way the dual mandate is being used. For most of Paul Volcker's term, he focused on price stability as the way to get unemployment down, and it did come down with that.

Recently, the dual mandate is already put forward as a reason to intervene, a reason for the quantitative easing. We heard much more about it recently.

I think the reality is when the Fed focuses too much on that goal, it gets worse. If you think of the 1970s, they focused on unemployment, and unemployment became high. In my view, one of the reasons unemployment is high now is because they focused on that too much in 2003, 2004, and 2005.

Mr. CARNEY. Dr. Meltzer, and I think Mr. Malpass, both said that you thought that the focus on monetary policy alone has taken the focus off fiscal policy. What would be more appropriate? Do you think the fiscal policy we have now is the right one, and what would be more appropriate, if not?

Mr. MALPASS. The issue is whether monetary policy is going to carry the burden of stimulus.

Mr. CARNEY. You said it shouldn't, and so what—

Mr. MALPASS. The Fed has taken on too much of that burden.

Mr. CARNEY. So what should we be doing on the fiscal side for stimulus?

Mr. MALPASS. There should be corporate tax reform. There should be a streamlining and simplification of the individual tax system, which is very cumbersome, and costly to the economy.

And on the regulatory policy side, we have an array of very costly Federal regulations that are burdensome.

Mr. CARNEY. Sorry for interrupting, but my time is expiring.

Dr. Meltzer or Dr. Taylor, on fiscal policy?

Mr. MELTZER. Fiscal policy—I agree with exactly what he said. And I think I want to emphasize what he said at the end. Regulatory policy, particularly at the present time, makes businessmen think that the Administration is hostile. I don't know whether the Administration is hostile or not, but they think it is hostile. That deters investment and creates uncertainty.

Mr. CARNEY. What about the idea of automatic spending cuts that are taking effect right now as part of that fiscal policy equation?

Dr. Taylor?

Mr. TAYLOR. The Congress has laid out a strategy to reduce spending gradually over time. I think moving back off of that would be a mistake. It would reduce the credibility of the government, so stick to the path that has been agreed to, try to deal with the sequester itself by giving flexibility to—

Mr. CARNEY. The problem was that it wasn't quite an agreed-to strategy. It was the fallback plan, if you will.

But thank you very much, each of you, for coming today and for your advice.

Chairman CAMPBELL. The gentleman's time has expired.

And now the gentleman from New York, Mr. Grimm, is recognized for 5 minutes.

Mr. GRIMM. Thank you, Mr. Chairman.

I will start off with Mr. Malpass.

Mr. Malpass, you mentioned before and in your testimony that the policies favor a select group, which would be the government, but not new businesses, small businesses, et cetera. Can you expand on that a little bit? Just because the average person out there would say, doesn't a small and new business benefit from having very low interest rates? So can you just explain that a little bit?

Mr. MALPASS. Thank you, Mr. Grimm.

The National Bureau for Economic Research has a study out this morning talking about how banks are actually responding to the current interest rate policy. It explains a little bit of what Mr. Huizenga was saying he felt in Michigan, that small businesses are having trouble getting credit, whereas larger businesses and, of course, the government are having an easy time getting credit.

My explanation in the testimony is that this is normal economic behavior when you fix the price of something. For example, if the government said that gasoline prices should be lower and then put a ceiling of $1.50 on a gallon of gasoline, what would happen? People who were privileged would get the gasoline. Businesses that were wasteful of gasoline would use too much. And that is basically going on.

The Fed has set the price of credit artificially low. It is causing people who don't need the credit—for example, the government or big corporations—to snarf up the credit and take too much.

Mr. GRIMM. I am sorry, because I have limited time. So basically what you are saying is, it sounds great in theory that new businesses and small businesses will also have low, low interest rates, but the truth is, they don't get access to the credit—to take—to get the benefits of those low interest rates.

Mr. MALPASS. That is exactly right.

Mr. GRIMM. Great. Thank you.

Mr. Meltzer, can you also expand for just 1 minute on why bankers applaud the current policy? And my question is, is it similar almost to an arbitrage, where it is a riskless transaction? I am going to borrow lower, then I know I can give it back to the government at higher, so there is really no risk. And if that is the case, if that is accurate, then does this limit—it goes back to what we just said—the appetite or the desire for a bank to lend to who they are supposed to be lending to, which is these businesses that desperately need it?

Mr. MELTZER. Yes. To amplify that, in addition to the interest rate, there is the risk. The bank looks at the risk and it says, "These new startups are a heck of a lot riskier than lending to the government. So I can make a good profit by borrowing from the Fed at a quarter of a percent or less and lending on government bonds at 1 percent or 2 percent, and why not do that and make a huge profit," which is what they are doing.

That isn't in the public interest and that isn't getting us toward the goal that we all agree on, which is good growth, a stable economy, and low inflation.

Mr. GRIMM. Dr. Gagnon, you had mentioned before, and I know it was touched upon when my colleague went into this, but I am still not satisfied, so I would like to just talk about it for the last minute. My understanding is that the Fed is buying up longer-term

instruments to push—put pressure on mortgage rates and the longer-term instruments that have interest rates as—to go down, as well. But they don't have any T-bills at all in their balance sheet.

If they don't have short-term instruments and interest rates do start to rise, the Fed has said that to avoid capital losses, they will hold them to maturity. But if they hold them to maturity then they don't have anything to sell to actually affect the interest rates or the potential for a run on the bond market. So isn't that dangerous?

Mr. GAGNON. No, because they have unlimited ability to repo them out to the market at short term—

Mr. GRIMM. I am sorry, say—say that one more time—

Mr. GAGNON. They can lend them to the market at short terms, so it is as if they sold short term—borrowed short term from the market. They can borrow short term from the market using them as securities—long-term bonds as securities, so they can regulate short-term interest rates that way.

And the key thing will be that they need to set interest rates where they need to be for the economy, and they have the tools to do that. They can print money; they can repo out securities; and they can choose whether or not they want to sell those bonds in their portfolio. I would urge them never to sell them.

Chairman CAMPBELL. The gentleman's time has expired.

The gentleman from Florida, Mr. Murphy, is recognized for 5 minutes.

Mr. MURPHY. Thank you, Mr. Chairman.

And thank you all for being here today. We appreciate your time.

Similar to many Members of Congress, I came here to talk about real solutions and what we can do to address the problems. I have been working very closely with the gentleman from North Carolina, who is stepping out, on focusing on a grand bargain, and I think that is perhaps one of the single biggest things we can do in our country to get our country on the correct fiscal path and then get out of the way.

In this hearing we have talked about unconventional monetary policy. What would it mean for unconventional monetary policy if Congress were to really do its job and get this grand bargain—in perhaps a perfect world, say we were to get this grand bargain immediately—what would that mean for monetary policy? And this is for all of you, starting with Dr. Gagnon.

Mr. GAGNON. I think the Federal Reserve traditionally is like the second mover in this process. The Federal Reserve looks at what Congress and the President do with regard to taxes and spending and then it responds as best it can, and that is always the way I think it needs to be, because the Federal Reserve has the ability to move quicker.

I think ideally you would like to delay spending cuts and tax increases until the unemployment rate had fallen further or inflation were a risk, neither of which is an issue now, and that would make the Fed's job easier, yes.

Mr. MURPHY. Dr. Taylor?

Mr. TAYLOR. I think a consolidation plan for fiscal policy would improve monetary policymaking because it would reduce a lot of

the uncertainty the Fed is trying to deal with. I think it is quite remarkable to me, a lot of the concerns I have about monetary policy—the unconventional, the unpredictability—also characterize fiscal policy. They go together and it hasn't always been that way. We used to have regular order for budgeting. We don't have that anymore so it is unpredictable.

So I think the more that fiscal and monetary policy can get more predictable, get more sensible, like you are trying to do, the better off the country will be.

Mr. MURPHY. Thank you.

Dr. Meltzer?

Mr. MELTZER. Yes. To your efforts, I say amen and good luck, because I can't think of any policy operation that would be more important at the present time than to put us on a predictable path to a balanced budget achieved over a sequence of years.

And what would it do for monetary policy? It would make—hopefully encourage them, make them do the corresponding thing: put us on a path toward price stability over the longer term. And the last thing that would need to be done would be to improve the regulatory policy.

But you are on a great track, and I wish you every good wish I can.

Mr. MURPHY. Thank you.

Mr. Malpass?

Mr. MALPASS. I will give a caution on the fiscal policy and also on the monetary policy, if I may. As I have seen the grand bargains done in the past, the concern is the taxes go up in the early years and the spending reductions are put off into the out years. Try to make sure that there are spending restraints at the beginning of the process.

I testified last week to the Senate Budget Committee and talked about the positive impact that has on the private sector. If the U.S. private sector saw the Federal Government in a continuous process of spending restraint rather than the one-off sequester that we are doing, a permanent process that held back the rapid growth that we keep seeing in government spending, it would cause a true boom. There would be job growth.

With regard to the Fed, I am worried that it will have trouble conducting monetary policy. It is true that they can repo bonds, but the Fed is right now the dominant player in the bond market, so it makes it very difficult and distortive to markets if the Fed were to begin a repo operation in an effort to conduct monetary policy under the current conditions. I think it would be disruptive for markets.

Mr. MURPHY. The question I propose is under a sort of perfect scenario. Under the reality of this Congress and the current dysfunction we have, what do you recommend, Mr. Malpass, that Fed Chairman Bernanke do in these times?

Mr. MALPASS. I mentioned earlier to stop digging the hole deeper. Because the policy is not working, the Fed's response has been to double the policy. And that has made it work even less well, so the growth rate has come down.

I would encourage the Fed to stop making promises about future interest rates and future bond purchases, to walk back.

Mr. MURPHY. Thank you.

Thank you all.

Chairman CAMPBELL. The gentleman's time has expired.

Without objection, Mr. Green of Texas will be recognized for 5 minutes.

Mr. GREEN. Thank you very much, Mr. Chairman. Thank you especially for allowing me to be an interloper, given that I am not officially a part of this committee.

I would like to thank the witnesses for appearing and to address Mr. Gagnon.

Sir, you have indicated from your testimony that you believe that more expansionary monetary policies are necessary. We do know that the Fed announced on December 12th that it would keep buying $40 billion in mortgage-backed securities per month and that it would begin buying $45 billion in long-term Treasury securities.

I assume that you concur with what the Fed is doing. Is that a fair statement?

Mr. GAGNON. Yes.

Mr. GREEN. All right. Given that you concur, will you elaborate on the type of monetary policies you think would benefit us, in terms of them being expansionary?

Mr. GAGNON. Sure. Over 3 years ago now, I warned that the Fed was on a path to being too tight and urged it to do a lot more in terms of buying long-term assets to hold long-term rates to get spending up. Over the years the Fed has belatedly, begrudgingly moved to pretty much do what I had asked 3 years ago.

At this point, I think what they could usefully do is to give some more assurance to the housing market that mortgage rates will stay low for a fixed period of time, perhaps 12 months. That would give banks comfort that if they want to make a mortgage to a borrower they can sell the MBS to the Fed at a fixed price, say 2 percent, for 12 months.

It would encourage banks to staff up their mortgage departments, to make more mortgage loans, and it would give house buyers that if they go into the market this year, they would have several months to shop for a house, and the credit would be there, and they wouldn't have to worry about rising rates. And it would really, I think, have a nice dynamic for the housing market. I think that is an important thing the Fed could do, which would be better than what they are doing.

Mr. GREEN. You also mentioned other types of refis. Would you elaborate on some of the other refis that might stimulate the economy?

Mr. GAGNON. What would really be helpful, and this is sort of beyond the Fed's ability, would be to really get the housing agencies to stop discouraging refinancing of old conforming mortgages. A lot of people still have 6 percent mortgages.

Mr. GREEN. Just for edification purposes, when you say "housing agencies," would you be more specific? Are you talking about Fannie and Freddie?

Mr. GAGNON. Yes.

Mr. GREEN. And that would be under FHFA?

Mr. GAGNON. That is correct.

Mr. GREEN. And that would be Mr. DeMarco?

Mr. GAGNON. That is correct.

Mr. GREEN. Continue, please.

Mr. GAGNON. I do not understand why FHFA has been allowed to not push the agencies harder. A refinance—fairly automatic refinance of—automatic approval of refinances of existing mortgages, mortgages that are already guaranteed by Fannie and Freddie but are paying high interest rates.

Mr. GREEN. For edification, are you saying an automated system that would allow FHFA to ascertain which of these products can be refinanced and streamline a process so that we can sort of clear out many of the homes where persons are underwater and would probably walk away from, some of them—I don't know how many, but a good many might—but if they can refi they will get a reduced payment and they will stay in that home. Is that some of what you are saying?

Mr. GAGNON. That is exactly what I am saying, and I think it would reduce the risk to the government, because if people can get a lower payment they are less likely to walk away from their mortgage. And since the government is already guaranteeing that mortgage, it is better to reduce the payment to make it less likely to fail.

Mr. GREEN. This is not something that the Fed can do; this is obviously within FHFA's purview.

Mr. GAGNON. That is correct.

Mr. GREEN. Now, quickly, one more thing: Are you familiar with the term, "expansionary fiscal contraction?"

Mr. GAGNON. Yes.

Mr. GREEN. Would you quickly explain, in your opinion, whether this term applies to the current economic circumstances?

Mr. GAGNON. Absolutely not.

Mr. GREEN. And if you would quickly, I only have 30 seconds, but maybe you will be allowed to go over to give your explanation.

Mr. GAGNON. One of the things we are learning is that the effect of fiscal policy on the economy depends a lot on the state of the economy and it depends a lot on how the Federal Reserve will react to fiscal policy. And so when the economy is booming, fiscal policy has a very big effect, because the Fed tends to offset it. If you cut taxes in a boom, it doesn't stimulate the economy any more; it just tends to raise interest rates.

But if you cut taxes or raise spending in a low state of the economy, the Fed will not react, and it will pass through to spending much more strongly. So a lot of studies are coming out and saying that fiscal policy has a big effect on the economy in a recession, but it has very little effect in a boom.

Mr. GREEN. Thank you, Mr. Chairman.

Chairman CAMPBELL. Thank you.

Without objection, we will go to a second round of questioning now and I will first recognize the gentleman from South Carolina, Mr. Mulvaney, for 5 minutes.

Mr. MULVANEY. Thank you, Mr. Chairman. I appreciate the second round of questions.

Dr. Taylor, I would like to talk to you a little bit, because you have introduced something in your written testimony and talked a little bit about it briefly today that was news to me—a new topic.

We have talked a little bit here today about the risks of the unconventional policy, and generally speaking, a lot of the debate has been focused on how maybe it is not working as well as it should or it is not working at all.

But you have introduced a new concept, which is that it is actually making things worse. And in your written testimony on page 7, you talk about the relationship, you say, "The perverse effect comes when the ceiling is below the—what would be the equilibrium between borrowers and lenders who normally participate in that market. While borrowers might like a near-zero rate, there is little incentive for lenders to extend credit at that rate." And then you go on to talk about the fact that with lenders not supplying enough credit that the decline in credit availability reduces aggregate demand, which tends to increase unemployment, "a classic unintended consequence of the policy."

That is the first I have heard of this. Would you mind exploring that a little bit with us, giving us more detail?

Mr. TAYLOR. Sure. It is very similar to what my colleagues over here have indicated, somewhat different words, and maybe mine is more academic-sounding, but it is very similar.

The idea here is if you think about monetary policy, it is not simply just the interest rate; it is the credit system. It is getting the funds from, if you like, the—intermediating from the lenders to the borrowers. And that credit system is not taken account of when you are thinking about the low interest rates. Of course you are going to stimulate some spending—investing with low interest rates, but if the credit doesn't come because of the very low interest rate because people don't want to lend at those rates, the margins are too small, then you will get—

Mr. MULVANEY. And that impact is immediate, isn't it?

Mr. TAYLOR. That is credit intermediation, yes.

Mr. MULVANEY. But, for example, we are talking about certain risks. There is risk of inflation—that is down the road. There is risk of credit bubbles, or asset bubbles—that would be down the road.

This depressing impact, the downward pressure on GDP that you are talking about, is happening right now.

Mr. TAYLOR. In my view, it is. I think it is something that isn't emphasized enough. You are thinking about risks in the future but it is a present issue. I think that is why the Fed has been disappointed in its policies, is the policies have been implemented and they haven't worked—that is my assessment—and so they have actually had more. They have done more of it, and I hope that vicious circle stops.

Mr. MULVANEY. Mr. Malpass, do you want to add something to that?

Mr. MALPASS. It is, sir, an immediate response because the market looks forward. In my work on this in 2009, I called it a rationing process, meaning if the Fed sets an artificial price for something then the market begins to ration through shortage, which is a very common economic phenomenon, and it is exactly what we have seen happen in 2010 in the credit markets of the United States.

I think as the Fed set this up they didn't think about the deleveraging going on in the banking system. They were thinking that if you put in a very low interest rate, it must cause more credit. Yet, the regulators were causing less credit or the same amount. So you have a rationing or a redistribution of credit rather than growth.

Mr. MULVANEY. Thank you, gentlemen.

Mr. Malpass, I want to stay with you on another topic, because my colleague from New York, Mr. Grimm, asked a question of Dr. Gagnon regarding exit strategy, and in response to one of his questions Dr. Gagnon suggested that maybe the Fed could hold these Treasuries to maturity but enter into the repo market. You didn't look very satisfied with that answer.

At the risk of asking a question I don't know the answer to, what were your thoughts on that, sir?

Mr. MALPASS. I am not sure I know the answer because we haven't done this before. The Fed has become an absolutely dominant player in the government bond market. In the past when the Fed did repo operations, they were a very small player in a large market. Now, they are a very large player relative to the market.

There are unpredictable consequences from the idea of the Fed lending a bond into a smaller market.

Mr. MULVANEY. Is it possible that the efficacy of that particular tool has been reduced because of the size of the balance sheet?

Mr. MALPASS. More than possible. It is likely that it has been reduced and probably wouldn't be very workable when the Fed gets to that point.

The point Mr. Grimm had made was that the Fed doesn't have any short-term Treasury bills. Dr. Meltzer is a world expert on Fed history. In the past, the Fed never used any other instrument than short-term Treasury bills and repos in a robust government bond market. We are in unexplored territory.

Mr. MULVANEY. Thank you, gentlemen.

Thank you, Mr. Chairman.

Chairman CAMPBELL. Thank you.

The gentleman from Illinois, Mr. Foster, is recognized for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman.

I would like to return for a moment to the issue of asset price—bubbles that—and I was interested in your view of the state of the art of macroeconomic modeling of the housing market, and in particular, whether various things can actually be understood in terms of how the housing market in other countries who have consciously suppressed housing bubbles and whether those things are accurately modeled. Can we get some understanding of possible policy or rules we can put in place, such as the one I mentioned, and how they might have worked and might work in the future to suppress housing bubbles in an automatic way. Because I personally, from a political point of view, am very skeptical that unless we have an automatic punchbowl retractor, it is going to be very difficult to hold back.

Anyone may answer.

Mr. MALPASS. I will make a brief comment. The point that you are making is very strong, that we need to have a countercyclical

policy. My one observation is we are actually going the other way. With each year the Federal Government is lowering the standards, making the equity requirement less and less for FHA.

I think you are right in what you are suggesting and I am afraid we are going the other way.

Mr. TAYLOR. I also think your concern about bubbles or excesses is well-taken. I think the experience, though, with monetary policy is that frequently the bubbles are coming at a time when policy is, if you like, overly easy. In other words, it is almost like the central bank is helping to cause the bubble rather than prevent it. And that is what I think we saw in 2003 and 2004.

It is also, if you look at Europe, countries which experience these real bubbles, say Greece and Ireland and Spain, the same kind of thing. One interest rate for Europe didn't really handle their situation. Often, it is the monetary policy that is the cause, so I would address that first.

And with respect to automatic changes in capital requirements, we haven't seen those work very well yet. But if it does, if we have something like that I agree 100 percent. It should be—

Mr. FOSTER. They were done sort of by fiat. For example, in Israel, they very aggressively turned up the downpayment requirements for houses, and you can imagine rules that kick in that force—at least for the federally-backed part of the mortgage market, you can imagine rules that would automatically pull the government out of the housing market when it starts to heat up.

I think that one of the things we are wrestling with is the phase lag between—the reason the system oscillates is that you are trying to regulate on lagging indicators, like unemployment, which is one of the most—

Mr. TAYLOR. Absolutely. I couldn't agree more. You need to work these through with models, and lags, and uncertainty, and there hasn't been enough of that done, unfortunately, to say this is what we should do, but I encourage it.

Mr. FOSTER. All right.

And on a related thing, there are various rules that you can imagine, and one of them is this so-called "targeting of nominal GDP," and it is an example of—it is one of the exit rules. If I remember properly, Dr. Taylor actually testified in 2010 on possible exit rules for—which is actually, the transparency as we exit I think will be important in getting business confidence back and the predictability of the system.

And one of those possibilities is simply to target nominal GDP and say it is simply the sum of inflation and GDP growth. Or you can obviously sort of feedback and try to regulate any linear combination of all the variables you can imagine, or some nonlinear function of them.

I was just wondering what you thought of that as a general approach.

Mr. TAYLOR. I think a predictable exit strategy is essential to lay out what the strategy would be when the time comes. And everyone wants to have stable nominal GDP growth. The question is, what should the Fed do to get that? What should the changes in the instruments be, the changes in the interest rate? And that is left open when people talk about a nominal GDP target so it needs

to be supplemented with some other kind of rule, if you like, for what the Fed should do to get to that target.

Mr. FOSTER. So the gain of the feedback loop, as it were.

Mr. TAYLOR. Yes.

Mr. FOSTER. Okay. I guess that is it.

I yield back the balance of my time.

Chairman CAMPBELL. Okay, thank you.

The gentleman from Indiana, Mr. Stutzman, is recognized for 5 minutes.

Mr. STUTZMAN. Thank you, Mr. Chairman, and I apologize if my question maybe repeats some of the questions that were asked earlier. I had to jump out due to another meeting, but I want to talk a little bit about the dual mandate, but also how the Fed's policies are affecting seniors, affecting Main Street, and what they are seeing and what they are feeling right now.

I have several friends that I spoke to before this hearing and just asked them what they are seeing and where people are putting money, and they said other than just the old principles of a balanced portfolio, there is nothing really out there that is attracting dollars because of Fed policy, low interest rates.

People are not putting money into CDs because there is not much return. Maybe they are getting pushed towards the stock market but people still are very wary of the stock market. My wife's grandmother, who lives on Social Security but has her savings, pulled everything out and is just sitting on it.

What kind of message is that sending from the Fed to Main Street? People are very skeptical and especially—and Dr. Taylor, I guess I will ask you this question, that the Federal Reserve predicted that GDP would be at 4 percent growth in 2012, but it actually just turned out to be 2 percent. Is it possible that the Fed's policies, whether it is dual mandate, it is working against American especially seniors right now, and especially the amount of retirees who are going into retirement, they are not seeing any growth in their pensions or their savings.

Mr. TAYLOR. Absolutely. That is the distributional effect that we are concerned about with monetary policy. It is helping some and hurting others.

I think the question about the overall effect being negative is based partly on that but also on the uncertainty that the policy is causing, which is a drag on investment. Remember, firms are sitting on a lot of cash, and they are holding back, and one reason is the uncertainty about monetary policy. Other policies too, but that is a big part of it.

And so again, you might think that low interest rates are good, and it is easy to talk about it and you can try to convince people, but there is this other side of the coin with the policy, which is actually, I think, a drag, and makes—one of the reasons why growth has been slower than the Fed forecast.

Mr. STUTZMAN. Mr. Malpass, I don't know if you would want to comment on that as well? And also, are we pushing more dollars into the stock market because there is just not the return on bonds, long-term or short, that could be creating a bubble here? We are just about to top the old record today. I haven't seen the numbers if we have, but I fear—

Chairman CAMPBELL. Dow is up 144.

Mr. STUTZMAN. I am sorry, what?

Chairman CAMPBELL. Dow is up 144, so they have blown through the record.

Mr. STUTZMAN. Did they? Okay.

Mr. MALPASS. One of the complaints is that the Fed is in so much control of this. The Fed was somewhat explicit over the last couple of years that it wanted to see more money go into stocks. I think that is too broad a role for the Fed.

There have been questions about the dual mandate today. It seems to me that there is a way to seek maximum employment in the context of price stability and those go together well enough. The Fed could go in a better direction. The Fed has gone way beyond the rules and the thoughts of what the boundaries should be. That creates risk for financial markets going forward and for the economy.

Mr. STUTZMAN. Anyone else want to speak to that or touch on that?

Let me ask just another question. Going back a little bit to where people are putting dollars, I don't know if Dr. Gagnon—what are we seeing internationally? Are we seeing the same trends internationally? Are we seeing anything that is different here that we could maybe learn from somewhere else or learn not to do?

Mr. GAGNON. Actually, that is a good question, because I think we do see different policies. The only other country that has really done what the Federal Reserve has done is the United Kingdom, and I think if you compare them to their neighbors in Europe, despite being much more the center of the—they had a much more important financial sector that was much more hurt by this crisis, and they have equally tough fiscal contraction right now—tax increases and spending cuts—and yet they are doing better than the rest of Europe, in part because they have chosen to do quantitative easing and Europe has not.

Mr. STUTZMAN. Thank you. I yield back.

Chairman CAMPBELL. The gentleman from Delaware, Mr. Carney, is recognized for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman. I have come back. I had a couple other questions I just wanted to ask, now that we have the distinguished panel before us, and it piggybacks a little bit on what my friend from Indiana was just talking about in terms of short-and long-term interest rates. At a conference in San Francisco recently, the Chairman of the Fed, in response to questions, said raising interest rates prematurely would carry a high risk of short-circuiting the recovery, possibly leading, ironically enough, to an even longer period of lower long-term interest rates.

The idea that if we short-circuit the recovery now then that is going to have that negative impact on the long-term. But Dr. Meltzer or Dr. Taylor, do you have any response or thoughts on that question?

Mr. TAYLOR. I think there is just a disagreement, different views about the impact of the policy. He feels that if he starts moving off of the quantitative easing or even just delays it, that is contractionary. I don't agree with that.

I think it is actually going to be a bonus or a benefit if we go back—it has to be gradual, as Dr. Meltzer indicated—to a policy that has worked in the past in similar circumstances.

Mr. CARNEY. What would your rule dictate? Your rule has been referred to several times.

Mr. TAYLOR. My rule would not have the quantitative easing. That is the most important thing right now. The interest rate would remain low but we wouldn't have the quantitative easing.

Mr. CARNEY. So the second question really relates to a statement that Dr. Meltzer made earlier that we are, in some ways, abdicating our constitutional responsibility for monetary policy here in the Congress, which suggested to me that somehow we ought to be, I don't know, involved. It is hard for me to believe that we could get it right. In fact, it sounds like the worst possible thing, to involve the Congress in the activities of the Fed. I just can't imagine.

Dr. Meltzer, I don't—you probably didn't mean that, but what did you mean by that, because I can't think of a worse idea, frankly.

Mr. MELTZER. Yes, I can't imagine the Congress doing that either, not running the policy. Prescribing a rule and enforcing the rule, that is what you want to do.

Mr. CARNEY. So isn't the rule—

Mr. MELTZER. So when the Chairman comes in here or the Members of the Board come in here to testify, you want them to say, "Look, in 2 years we are going to have low inflation and high employment, and these are the numbers that we are aiming for."

And then 2 years later when they come in you can say, "Well, you didn't get there, so what we want you to do is explain to us why you didn't get there, and if we don't think the explanation is good, we think you should resign and we will get people who can do the job better." That is what I think is the Congress' responsibility. It is an oversight responsibility.

Mr. CARNEY. Yes, so we—

Mr. MELTZER. What you have now, it is just very difficult for you to do it because the Chairmen—not just Chairman Bernanke but Chairman Burns, Chairman Volcker, Chairman Greenspan—can run circles around you talking about things that are very difficult to sort out and for you to clearly know.

Mr. CARNEY. That is a fact.

Mr. MELTZER. Yes.

Mr. CARNEY. Just like this panel can as well, I might add, but—

Mr. MELTZER. I don't think we are trying to do that. I think we are trying—my own view and I am sure the view of my colleagues here, including Mr. Gagnon, are trying to help you.

Mr. CARNEY. I appreciate that. And we do, I think, have a framework anyway. It is called Humphrey-Hawkins. We had a conversation about that a few minutes ago, and you conceded that the full employment piece, although it wouldn't be your preference, it is a political thing, and of course, that is what drives us. We are driven by the people that we represent every—

Mr. MELTZER. Yes, and you need to add to Humphrey-Hawkins something which incentivizes the Fed to pay attention to it, and that is—

Mr. CARNEY. In terms of a rule.

Mr. MELTZER. That is the rule and the addition to the rule, which says if you don't hit the target that you said you were going to hit, if you don't achieve what we have told you to achieve or what you have told us you were going to achieve, then you have to tell us why and offer a resignation, and political authorities have to be willing to make that choice. That gives incentives.

Regulation that is goodwill regulation doesn't work. Regulation works when they incentivize the people who are regulated. That is what you need to do both in banking and with the Fed. You have to give them an incentive to follow the rules which you and they agree upon.

Mr. CARNEY. I see my time has expired.

Let me thank each of you again for coming and for your expertise and your advice.

Chairman CAMPBELL. The gentleman from Delaware yields back.

And now, the vice chairman of the subcommittee, the gentleman from Michigan, Mr. Huizenga.

Mr. HUIZENGA. Again, thanks, Mr. Chairman, for doing this.

And I want to thank the panel for coming in. I can tell you that every time I have a conversation with you all, I feel like I am making significant leaps toward having a Ph.D., or maybe a master's, in banking and financing and economic theory, so thank you very much.

I have a couple of very short, kind of quick questions. In your opinion, who is benefitting the most right now from our current policy? And I would love to have you just kind of go down the row. Who is benefitting from it and is this the path that we need to be on?

Mr. MALPASS. My thought is that the government is the biggest beneficiary because it is the biggest debtor. The interest rates are being kept artificially low; that helps the debtor. The cost is borne by the savers, and in the United States the biggest saver is the household sector. So it is a direct transfer from the private sector saver to the government.

Mr. MELTZER. I agree with what he said, the government, but I would add, would you vote for a policy which said, we are going to bail out the banks and increase their returns?

But that is what the Fed is doing. It is allowing them to borrow from the market or from the Fed at a quarter a percent or less and lend to the Treasury for 1 percent or more, and they make big profits.

What is the social benefit of that? None, as far as I am concerned. It has a social cost, and that social cost is high because it is keeping interest rates too low, and we have talked about that a lot.

So you wouldn't vote for that policy and yet you have that policy.

Mr. TAYLOR. I just think it is focused on the overall macro effects, which I think are negative, in terms of trying to figure out who are the winners and who are the losers here. It is very difficult. But I would say my main concern is that the overall effect is negative.

Mr. GAGNON. I would say the beneficiaries, as Mr. Malpass said, are the U.S. Government, the Federal Government particularly, as I said before, but also, younger people and people with mortgages

are benefitting. I think the people who are losing are, it is true, older savers are losing something, and the other big loser is foreign governments who are investing in our country and getting a low rate of return and I think that is fine.

Mr. HUIZENGA. But it is fair to say it is not the mom sitting around the kitchen table trying to figure out how she is going to feed her kids and how she is going to put gas in the minivan, and all those things, right?

Mr. GAGNON. Well, if she has a mortgage and she refinanced it, she is much better off now.

Mr. HUIZENGA. If she qualifies, if she can get through the Dodd-Frank Act.

Mr. GAGNON. Yes, that is an issue—can I make one very brief—

Mr. HUIZENGA. Please.

Mr. GAGNON. —point about—one thing I don't understand is this talk about credit rationing. It seems to me that is confusing the level of rates with the spread of rates. Banks charge a spread over what they can borrow at. The Fed sets that at zero and no one tells the banks how much—limits how much they can charge on—to borrowers, so there is no rationing going on.

And if you give banks a lower cost to funds, they can lend it at a lower rate. So I don't see any way this could hurt—

Mr. HUIZENGA. That beautifully ties into my next question, actually, which is, I would like you all to touch on what some of the effects are of the regulation that has been on there. And this might be a little outside of what we are specifically talking about today but it seems to me it is not just our spending and it is not just monetary policy; it is the regulatory environment and the tax policy that dramatically impacts that, and I hear that all the time.

And I used this with Dr. Bernanke. It is not one grain of sand that is going to gum up the works on that machine, and you can't—who can argue with, okay, one little grain of sand, a regulation that is going to be added, but when suddenly it is a whole handful and suddenly you are using a rubber mallet to pound it into the gears, now you have a problem, and it seems to me that we have done that. So that might go to some of my concern about what you are bringing up, but would anybody care to comment?

Mr. MALPASS. When I say the government is the beneficiary, I mean in the sense of Washington, D.C., government employment, and the real estate boom. This is the center of the beneficiary of these policies, whereas outside of Washington is having a harder time.

And with regard to the regulatory side, Sarbanes-Oxley and Dodd-Frank are putting very real costs onto businesses. The regulators in the banking sector are causing challenges in the allocation of capital. Some banks are able to make more loans, but many banks are constrained or scared by the regulators into not making loans that are considered risky loans.

Mr. HUIZENGA. I know my time has expired, but I appreciate that.

And if anybody has any other comments they would like to share in writing, I think probably, or unless the chairman so chooses to do something different, I would love to hear your views, so—

Chairman CAMPBELL. I thank the gentleman.

And the gentleman's time has expired. I saved myself the final 5 minutes to bat cleanup, and so I will yield myself 5 minutes at this time.

I think this hearing has been very interesting, very productive, and very helpful. And one of the things that has come to me from this hearing that I didn't necessarily have coming in was, the risks of the current monetary policy out—the sort of tail risks are obvious. The Fed acknowledges them, et cetera.

What I heard today was a lot of not risks but, in fact, negatives—current negatives. Things that are from the current monetary policy that are depressing current employment and current GDP growth, which—and I would like to just touch on a few of these.

One we talked about was the loans being priced below where they should be, and even if milk is free, it doesn't help you if you can't get it. Now, Dr. Gagnon just suggested that it is about the spread and not about the price of the loans. How do those of you who believe that is a constricting factor respond to Dr. Gagnon on that?

Mr. MELTZER. If a bank can lend to the government and make quite nice profits, why would it want to take risk that—to a new, unsecured—

Chairman CAMPBELL. So are you saying, then, that the spread between a no-risk loan and a risk-loan has compressed?

Mr. MELTZER. And that is what they are doing.

Chairman CAMPBELL. Right. Okay.

Dr. Gagnon?

Mr. GAGNON. I would say that the issue is whether that is because of monetary policy, or because of regulatory policy, or because banks have felt they have been burned through their misbehavior in the past and are overcompensating now, and—

Chairman CAMPBELL. Okay, but it is probably a fact, though, right, that spread is down and that is going to limit the availability of loans?

Mr. GAGNON. I don't see it from the point of view of monetary policy. I do see it from the point of view of regulatory policy and bank—

Chairman CAMPBELL. However, it may be the—

Mr. MELTZER. Of course, it is due to monetary policy. It is the monetary policy which is keeping the interest rates down there and telling banks—Dr. Taylor wrote a piece in The Wall Street Journal and talked about it here. Sure, the borrowers want to borrow, but try to get a mortgage if you are an unsecured, not-well-known borrower coming into the mortgage market. You just won't find a bank or mortgage company that is going to want to lend to you when that is the case.

If you are a commercial real estate operator speculating on the future of asset prices, commercial market prices in New York or the Silicon Valley, you can get all kinds of credit.

Chairman CAMPBELL. Okay.

We talked about cash on balance sheets not deployed, and it is not just on corporate balance sheets. Again, I see that anecdotally all the time—people just sitting on cash because interest rates are

too low, returns are too low now but they think they are going to go up in the future so they just sit.

And so everybody just sits until the Fed takes action. Rather than trying to read a market, they are trying to read what the Fed is going to do, which is very distorting, in my view.

We talked about banks borrowing at a quarter percent and selling to the Treasury at a percent. Older people or savers—and, Dr. Gagnon, you acknowledged this as well—are losing in this environment. And when I asked Chairman Bernanke last week about how the benefits of this were going to big banks and governments, he pushed back hard, saying, "Oh, no, no, there is all this employment and stuff that is being created."

We haven't looked at all the things. What are the cutbacks of savers? What are they doing differently? What are seniors who are largely or partially dependent on fixed incomes doing to cut themselves back on that?

And then, Dr. Gagnon, you said a minute ago that you felt—you acknowledged that but you felt younger people were getting some benefit, and I saw a great deal of angst from the other end of the table when you said that.

So either Mr. Malpass or Dr. Meltzer, I believe both of you lit up on that?

Mr. MALPASS. The unemployment rate for young people is very high, and that is, I think, in part the result of a contractionary and distortive monetary policy.

Mr. MELTZER. What Chairman Bernanke never says or discusses is, why is this the slowest recovery in the whole post-war period? There hasn't been another one like this since 1937 to 1938. It is very slow, harming lots of people, especially new entrants to the labor force.

That is a question which the Fed doesn't approach. It is helping bankers make large profits lending and borrowing with the government. That is not a policy which gets us substantial growth and employment.

Chairman CAMPBELL. Thank you.

My time, and all time having expired, I very much appreciate all four of you coming. And I very much appreciate the nature and tenor of the discussion, and as I said, I think it was very helpful.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

The hearing is now adjourned.

[Whereupon, at 12:17 p.m., the hearing was adjourned.]

A P P E N D I X

March 5, 2013

America Needs More Expansionary Monetary Policy

Joseph E. Gagnon, Senior Fellow
Peterson Institute for International Economics
March 5, 2013

Statement before the hearing entitled, "Near-Zero Rate, Near-Zero Effect? Is 'Unconventional' Monetary Policy Really Working?" Subcommittee on Monetary Policy and Trade, Committee on Financial Services, United States House of Representatives

Why Is this Recovery So Slow?

There are four major forces preventing a rapid return of the US economy to its full potential: 1) households have increased their rate of saving to make up for losses in the value of their houses and to prepare for retirement; 2) banks continue to apply tighter-than-normal standards and terms on loans to households and businesses; 3) foreign governments continue to send record levels of capital into US markets in order to prevent their currencies from appreciating and thus perpetuating a large US trade deficit; and 4) state and local governments, constrained by balanced budget rules, cut spending and raised taxes during and immediately after the recession. Although the last of these forces appears to have run its course, tax increases and spending cuts at the federal level are now taking over as a major factor retarding growth this year.

All of these forces reflect either greater saving or reduced borrowing, both of which hold down spending in the US economy.

What Can Monetary Policy Do?

Monetary policy influences the level of spending in the economy by changing the returns to saving and the costs of borrowing. Interest rates, both short-term and long-term, are convenient measures of both the return to saving and the cost of borrowing. Higher interest rates encourage saving, discourage borrowing, and thus reduce total spending. Right now, total spending in the US economy is too low. The appropriate monetary response is to lower interest rates to discourage saving and to encourage borrowing and thus spending.

Appropriate monetary policy helps to speed the economy's return to equilibrium. Inappropriate monetary policy, on the other hand, can push the economy away from equilibrium. Thus, excessively tight policy can cause a prolonged recession, whereas excessively loose policy can cause runaway inflation. Right now, there is no reasonable doubt that the US economy is below its equilibrium level of output. The case for easy monetary policy is strong.

One caveat to this prescription is that monetary policy affects spending with a lag, typically estimated to be around one to three years. Thus, policymakers need to look forward and to set interest rates to guide the economy to equilibrium roughly two years in the future. According to the Blue Chip survey of private-sector forecasters, in the fourth quarter of next year the unemployment rate is expected to be 7 percent and the inflation rate is expected to be 2 percent. The same forecasters report an expected long-run rate of unemployment of less than 6 percent. Apparently, private-sector forecasters do not expect the economy to return to equilibrium within

two years. I would also note that these forecasters have been repeatedly surprised by how low inflation has turned out to be over the past three years. I expect inflation to be less than 2 percent next year. The bottom line is that a consideration of how the economy will evolve over the next two years leads to the conclusion that the current stance of monetary policy is too tight.

What Is Different about Unconventional Monetary Policy?

Normally, monetary policy operates directly on the short-term rate of interest on high-quality assets. Longer-term rates of interest and rates of return on other assets move more or less in sync with the short-term interest rate, reflecting expectations about monetary policy in the future and financial arbitrage. When the short-term interest rate hits zero, the monetary authority can no longer ease policy through this tool. However, the underlying source of monetary power is the ability to print money to buy assets, and this power is not limited to purchasing only short-term assets. One element of unconventional monetary policy is to use newly printed money to purchase unconventional assets. Another element of unconventional policy is to communicate to market participants that the future path of the short-term interest rate will be lower than they might otherwise expect. In these ways, the monetary authority can influence longer-term rates of interest, as well as the rates of return (and thus the prices) of any financial asset it chooses to buy or sell.

My research shows that purchases of long-term bonds by the Federal Reserve have lowered long-term interest rates not only on the bonds being purchased but also on a broad range of long-term assets. Other researchers have confirmed this result, including in the United Kingdom, which is the only other country to have tried large-scale purchases of longer-term assets. I estimate that the 10-year Treasury yield and the 30-year mortgage rate are at least 1 percentage point lower than they would have been in the absence of the Federal Reserve's unconventional policies.

Most market participants believe that these policies have boosted stock prices and helped to keep the dollar from appreciating. There is no doubt that all of these financial developments encourage spending—consumption, investment, and exports—and thus support economic growth. I note in particular that refinancing long-term debts at lower interest rates goes a long way toward repairing household and corporate balance sheets that are holding back spending.

What Are the Costs of Unconventional Policy?

Chairman Bernanke has identified four costs or risks that are of greater concern with unconventional monetary policy than with conventional policy. Three of these costs arise because unconventional monetary policy requires much larger fluctuations in the balance sheet of the monetary authority than conventional monetary policy. In my view, none of these costs is close to being significant now or at any time in the foreseeable future.

1. The first cost of unconventional monetary policy is that the Federal Reserve could become the dominant buyer and holder of long-term Treasury and agency securities, thereby reducing the liquidity and efficiency of the markets for these assets. So far, this concern is purely hypothetical and it would almost surely require far greater purchases than most people expect to occur over the next couple of years. But if it should ever occur, the Federal Reserve could

address this problem by announcing adjustable daily target ranges for the yields of the securities it is buying. To hit these targets it would accelerate or decelerate its rate of purchase within the day. That would give market participants some assurance about the price for which they could buy and sell Treasury securities at any time, which is the operational definition of a liquid market. More broadly, one of the main purposes of quantitative easing is to force investors out of the market being targeted and into other markets, which would become more liquid. The Treasury yield curve can still provide a market benchmark even if private investors hold most of their portfolios in other markets.

2. The second cost is that the public might believe that it will be difficult for the Federal Reserve to tighten policy at the right time to prevent excessive inflation in the future. This fear might increase uncertainty and instability in markets. The key to preventing this cost from materializing is constant communication by the Federal Reserve about its capabilities and intentions. The Federal Reserve has developed several tools to adjust policy that provide ample scope for future tightening. However, the real concern may be more with the Federal Reserve's willingness than with its ability. Experience shows that inflation fears are highly sensitive to strong policy actions (or the lack thereof) in response to observed inflation. Thus the Federal Reserve needs to calibrate its policy stance visibly in response to deviations of both unemployment and inflation from their previously projected levels.

3. The third cost is that low long-term yields may encourage risky behavior that threatens financial stability. Some observers have argued that we are already seeing a risky bubble in the bond market. But low long-term yields are not a bubble when they reflect expectations of the path of the short-term interest rate that are guided by the monetary authority and are supported by its holdings of long-term securities. It is unlikely that systemically important institutions are holding excessive long positions in bonds, and it is the job of risk managers at those firms, prudential supervisors of those firms, and the new Financial Stability Oversight Council to prevent such behavior. Moreover, by boosting the economic recovery, increasing corporate profits, and decreasing the rate of bankruptcies, unconventional monetary policy reduces risks to financial stability considerably.

As Chairman Bernanke said last month, the current low level of interest rates reflects the weakness of the economy. The sooner we can return to full employment, the sooner we will return to normal levels of interest rates. Premature tightening will only delay the return to normalcy. Indeed, in my view, if the Federal Reserve had been more aggressive in easing earlier, we might already have returned to normal levels of interest rates by now.

4. The fourth cost is the possibility that the Federal Reserve could incur financial losses on its enlarged balance sheet. This so-called cost is a complete red herring. Indeed, the most unremarked benefit of unconventional monetary policy is the way it reduces the burden of our national debt for future generations. Since 2009, the Federal Reserve has passed to the Treasury record profits from unconventional monetary policy, and it is likely to continue to do so for the next few years. Any losses in the more distant future must be examined in tandem with the previous windfall profits. In addition, the Treasury also has benefitted from higher tax revenues and from issuing debt at lower interest rates. There is no plausible scenario in which unconventional monetary policy could raise the long-term burden of our national debt.

4

Should the Federal Reserve Have a Dual Mandate?

Monetary policymakers around the world act as if they have a dual mandate, even in countries where the only formal mandate is for price stability. It is not in the interest of accountability and transparency to pretend that monetary policy does not affect employment and output or to pretend that society does not care about employment and output. The dual mandate has served us well and we should keep it.

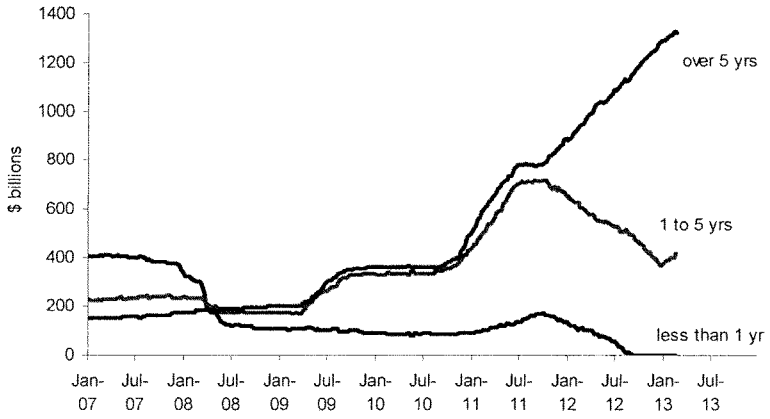
Statement of
David R. Malpass before the
House Financial Services Committee
Monetary Policy and Trade Subcommittee
March 5, 2013

Chairman Campbell, Congressman Clay, members of the Committee, thank you for the invitation to testify on the effectiveness of current monetary policy. It is a great pleasure to join Allan Meltzer, John Taylor and Joe Gagnon on this panel.

I think Federal Reserve policies have been weakening and distorting the economy rather than providing stimulus. The policies are hurting savers, distorting markets, and redistributing capital rather than increasing it. The policies subsidize government, big corporations, big banks, foreign investment and gold, none of which is a robust private sector job creator, at the expense of small and new businesses and other job-creating parts of the economy. The result is a departure from market-based capital allocation that is contractionary in the same way that price controls, income redistribution and industrial policy are contractionary.

The Fed funds rate has been near zero for over four years, unique in our history. By borrowing heavily from banks, the Fed has expanded its balance sheet by more than $2 trillion (from $900 billion to $3.1 trillion). It has substantially lengthened the duration of its assets by selling all of its Treasury bills, which were once a mainstay of monetary policy, to buy longer-term Treasuries. This leaves the Fed with substantial interest rate risk and marks the end of an era for the Fed's once ultra-liquid balance sheet.

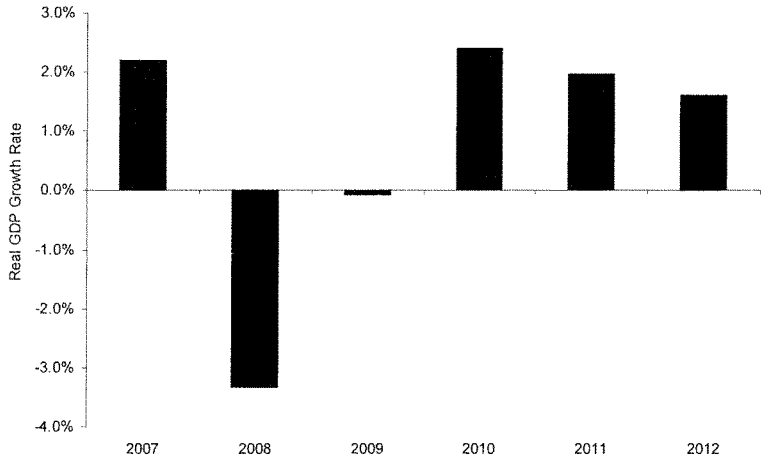
Maturity of Fed Treasury Security Holdings (last obs. February 20, 2013)



Source: Federal Reserve; Encima Global

The result is an experiment in extreme monetary policy. It hasn't worked, as shown by the weakening of the expansion. Real growth has slowed from 2.4% in 2010 to 2.0% in 2011 and 1.6% in 2012. Nominal growth, where a stimulative Fed policy should have its most influence, has also slowed – from 4.3% in 2010 to 4.0% in 2011 to 3.5% in 2012. **In effect, the U.S. economy has been going backwards. It is showing unprecedented weakness during an expansion, evidence of poor monetary, fiscal and regulatory policies.**

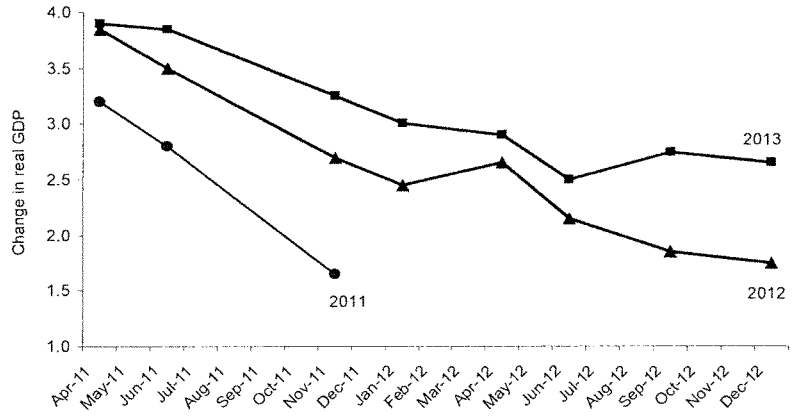
Real GDP Growth (4th qtr/ 4th qtr, last obs. 2012)



Source: Bureau of Economic Analysis; Encima Global

The Federal Reserve had to lower its original growth projections for 2011, 2012 and 2013. Some of the economy's underperformance is due to factors such as uncertainty over tax policy, Europe's debt crisis and the trauma during the August 2011 debt limit increase. However, I think there is also a problem in the transmission mechanism of QE to the economy. It isn't working under current circumstances of heavily regulated growth in private sector credit, so economic growth has been coming in below the Fed's expectations. The longer the harmful monetary policy persists, the more the weight on the economy, making the distortions more difficult to unwind.

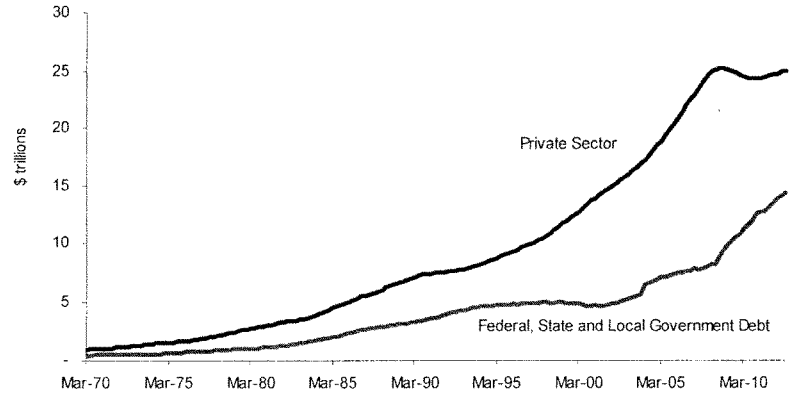
Fed Projected Real GDP Growth Rates (last obs. December 12, 2012)



Source: Federal Reserve; Encima Global

The money multiplier that connects the Fed's creation of bank reserves to private sector credit growth has simply stopped functioning under current monetary and regulatory policies. The Fed's balance sheet has been expanding without a corresponding expansion in private sector credit. Private sector credit growth was up only 1.6% ($384 billion) in the 2010-2012 period (through Q3), one of the factors holding the nominal GDP growth rate down. By comparison, government debt rose 32.4% ($3.5 trillion, nearly ten times as much) and the Federal Reserve's liabilities rose 30.6% ($669 billion.)

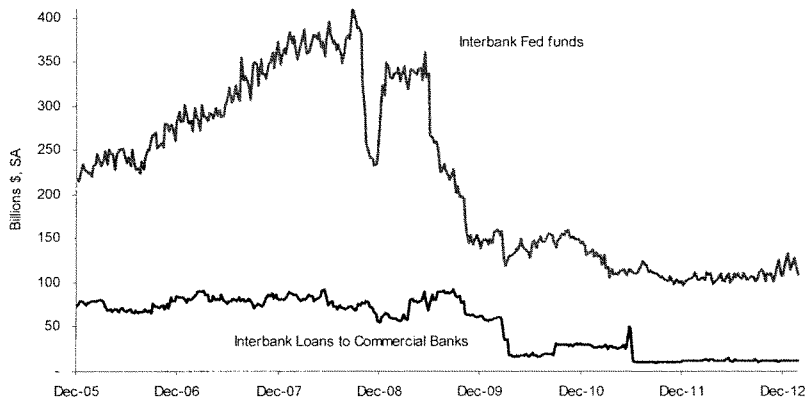
Private and Public Sector Debt (last obs. Q3 2012)



Source: Federal Reserve; Encima Global

The Fed is setting short-term interest rates artificially low. This creates risk and uncertainty in the outlook. In the Fed's September FOMC statement, it promised low future interest rates. It hopes this will encourage consumer spending, but it also undercuts the normal impetus to borrow during a recovery to lock in low rates before they go up. The low-rate policy penalizes savers, distorts capital allocation and undermines critical interbank markets, one of the many problems Professor Ronald McKinnon has highlighted.

Loans through Interbank and Fed Funds Market (last obs. Feb. 22, 2013)



Source: Federal Reserve; Encima Global

The Fed is also pushing down yields for longer-term credit, benefitting a select group of favored borrowers at the expense of non-favored borrowers such as new businesses, small businesses and businesses considered risky by government regulators. Per Fed policy, the weaker the labor market, the more government bonds the Fed will purchase, with no limit. This threatens the private sector with an even more distorted capital allocation process, creating a feedback loop that discourages productive investment.

These distortions have been hurting economic growth throughout the recovery, as discussed in my December 4, 2009 Wall Street Journal article titled Near-Zero Rates Are Hurting the Economy: "Capital is being rationed not on price but on availability and connections. The government gets the most, foreigners second, Wall Street and big companies third, with not much left over... For small businesses and new workers, capital rationing is devastating, spelling business failures and painful layoffs. Thousands of start-ups won't launch due to credit shortages, in part because the government and corporations took more credit than they needed because it was so cheap."

By under-pricing credit for certain borrowers while applying regulatory limits on traditional lenders, credit ends up being rationed. The Fed stands ready to lend money to the government and the government-backed mortgage market at any price. Since regulators are enforcing capitalization and leverage requirements, the result of Fed bond purchases is a crowding out of lending to small and new businesses. As low rates are pushed out along the yield curve, capital is increasingly misallocated toward government and big corporations. This shows up in declining growth rates and less economic dynamism.

In addition to the contractionary economic impact, current monetary policy raises several other negatives:

1. The Fed is buying some of the most high-priced assets in the economy -- Treasury bonds and MBS -- long after the 2008 financial crisis. Some of the steps the Fed took in the heart of the 2008 crisis were beneficial, for example the reduction in the Fed funds rate from 2% to 1% in October 2008 and the Fed's purchase of high-yielding agency MBS to unfreeze the market in November 2008. However, the huge expansion of non-traditional measures in 2009-2012 extended well after the end of the crisis, harming market-based capital allocation.

2. The Fed has greatly expanded its role in the economy, financial markets and capital allocation. The Fed has asserted the legal authority to make unlimited "large-scale asset purchases" on its sole discretion even when there's no systemic crisis. That has huge implications for the future, when each slowdown will cause the markets to believe the Fed might buy assets.

3. By using short-term financing (overnight bank loans) to buy long-term bonds, the Fed is creating a maturity mismatch for itself and is shortening the effective maturity of the national debt. In just four years, the Fed's balance sheet has been transformed from the world's most liquid to the most mismatched in terms of maturities. Leveraged 30:1 (or 50 to 1 counting currency outstanding), the Fed is using $1.7 trillion of bank reserves as primary funding for $2.8T in very long maturity assets while maintaining only $55 billion of equity capital.

4. The Fed's massive buy-back of long-duration bonds has lengthened the effective maturity of the national debt, overwhelming the Treasury's important role in deciding the maturity. The result is a much more powerful Fed and a risk to taxpayers when interest rates are eventually allowed to return to market-based levels and the government refinances the debt at higher interest rates.

5. The Fed now owes nearly $2 trillion at floating interest rates to a small group of commercial banks. This has taken the place of Treasury debt held by the private sector, which would have been broadly placed in the market (and would pay a slightly lower interest rate than the Fed's 0.25% rate paid to banks.) When interest rates rise, the Fed and taxpayers will face a large increase in their interest

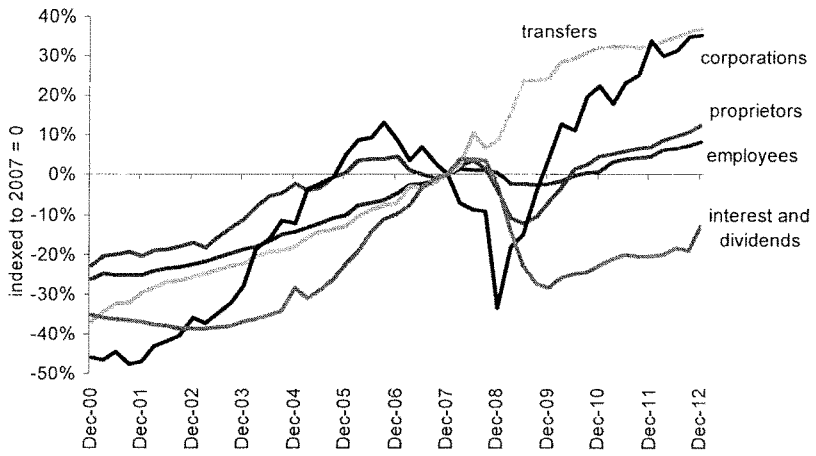
payments to commercial banks, creating severe political challenges and market uncertainty.

6. By connecting monetary policy to a specific 6.5% unemployment rate, the Fed has changed its mandate, in effect making itself accountable for a particular unemployment rate even though its policies don't control the rate. The Fed should be focused on maximizing employment and keeping inflation low. The new target and the Fed's giant bond portfolio interfere with the Fed's decision process in achieving its statutory mandate.

7. The Fed is actively managing consumer and market sentiment and encouraging risk-taking rather than relying on the quality of the monetary framework to encourage investment and hiring. In his September 13, 2012 press conference, Fed Chairman Bernanke said that the Fed assuring the public that it will take action if the economy falters should increase confidence and boost the willingness to spend. This Fed assurance that it will take action to support the economy is often described as the Bernanke put, a reference to a financial derivative that provides protection against losses. It is named after the Greenspan put, which equity and housing markets relied on to justify high leverage ratios in the 2000s on the view that then-Chairman Alan Greenspan would keep interest rates low enough that asset prices were sure to increase. Over-confidence in the low-rate environment of 2004-2007 gave rise to the view that banks and investors should "dance until the music stops," a process the Fed may be repeating. Interest rates and Treasury bond yields are well below the nominal growth rate and the inflation rate, a measure of the market distortion.

Current policy is causing a massive shift in the sources of income in the U.S. economy, with government transfers and corporate profits growing much faster than the income of sole proprietors and employees. This distortion in income growth is a major departure from historical norms. Since 2007, transfers are up 37% and corporate income up an estimated 35%, both of which benefit from zero interest rates and Fed bond purchases, whereas the other two components combined are up only 9%.

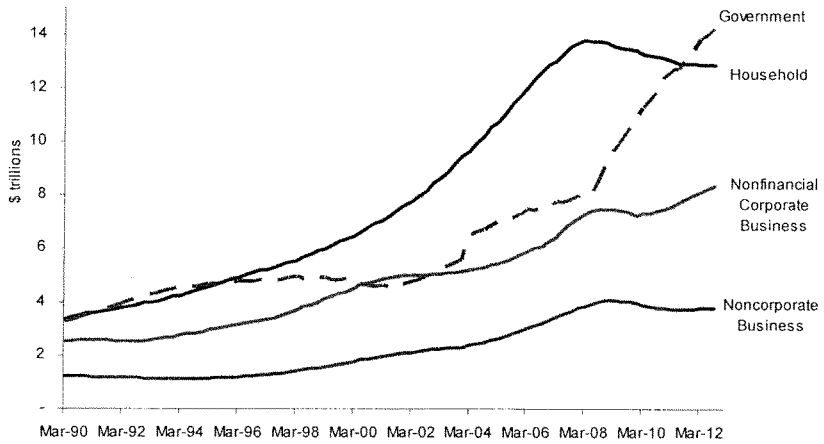
Income and Profits Distorted (last obs. Q3 2012, corp. profits Q4 estimate)



Source: Bureau of Economic Analysis; Encima Global

The Federal Reserve's flow of funds data shows large distortions in the patterns of credit growth, making clear the dramatic shift in the allocation of credit to government and corporations (graph below.) In the year ending September 30, credit to the government was up 8.9% to $14.3 trillion (including federal, state and local marketable debt). Private sector credit was up only 1.9% year-over-year to $25 trillion. Credit to corporations was up 6.3% to $8.4 trillion, but non-corporate credit was up only 1% to $3.8 trillion and credit to households was down 0.5% to $12.8 trillion. The December 31 data, due from the Fed on March 7, is likely to show the same trends.

Debt by Major Sectors (last obs. September 30, 2012)

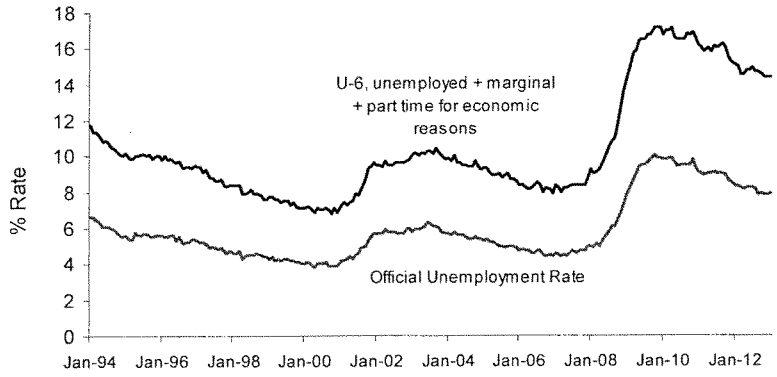


Source: Federal Reserve; Encima Global

Fed Chairman Bernanke raised this problem of capital mis-allocation directly in his August 27, 2010 Jackson Hole speech: "Generally speaking, large firms in good financial condition can obtain credit easily and on favorable terms… bank-dependent smaller firms, by contrast, have faced significantly greater problems obtaining credit… Through the provision of specific guidance and extensive examiner training, we are working to help banks strike a good balance between appropriate prudence and reasonable willingness to make loans to creditworthy borrowers."

This points to a very government-intensive process of credit allocation that has been one of the root causes of slow growth and poor capital allocation in the 2010-2012 period. The result has been weak growth in employment, leaving unemployment very high as small and new businesses lag.

Unemployment and Underemployment (last obs. January 2013)



Source: Bureau of Labor Statistics; Encima Global

Asset Price Theory

The Fed has put forward an asset price theory for transmitting QE into growth. In his November 14, 2010 Washington Post article, Chairman Bernanke said: "Higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

In his November 4, 2010 Washington Post article, the Chairman emphasized the spending pathway, writing that monetary policies should ease financial conditions, which would promote economic growth. "Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

Over the course of the Fed's bond-buying, however, the virtuous circle has applied more to equities and some other financial assets than to the real economy, which has weakened year by year. For example, high-yield bond markets are hot, but don't create many jobs. I discussed the problem of asset price inflation in my October 19, 2010 Wall Street Journal article titled How the Fed is Holding Back the Recovery: "The Washington policy consensus for a decade has been 'print and spend.' When that doesn't work, the Washington prescription is to double the dose—more monetary easing and dollar devaluation, and always more government spending. The Fed in particular has become accustomed to subsidizing federal borrowing by holding interest rates too low, which distorts capital flows and fosters asset bubbles."

Fed Governor Jeremy Stein's February 7, 2013 speech at the St. Louis Fed (Overheating in Credit Markets) concludes that there is "a fairly significant pattern of reaching-for-

yield... Overheating in the junk bond market might not be a major systemic concern in and of itself, but it might indicate that similar overheating forces were at play in other parts of credit markets." Separately, Dr. Stein points out that: "The maturity of securities in banks' available-for-sale portfolios is near the upper end of its historical range... In the spirit of tips of icebergs, the possibility that banks may be reaching for yield in this manner suggests that the same pressure to boost income could be affecting behavior in other, less readily observable parts of their businesses."

Portfolio Balance Theory

The Fed's primary explanation of the transmission mechanism of QE to the economy is through the theory of portfolio balancing. In his August 27, 2010 Jackson Hole speech, Fed Chairman Bernanke explained in detail how he envisioned Fed asset purchases adding to economic growth: "Such purchases work primarily through the so-called portfolio balance channel, which holds that once short-term interest rates have reached zero, the Federal Reserve's purchases of longer-term securities affect financial conditions by changing the quantity and mix of financial assets held by the public... For example, some investors who sold MBS to the Fed may have replaced them in their portfolios with longer-term, high-quality corporate bonds, depressing the yields on those assets as well... Our purchases of Treasury, agency debt, and agency MBS likely both reduced the yields on those securities and also pushed investors into holding other assets with similar characteristics, such as credit risk and duration."

During his December 12 press conference, the Chairman again explained the transmission theory: "What matters primarily is the mix of assets on the balance sheet... the fact that we're acquiring Treasury securities and MBS, taking those out of the market, forcing investors into other closely related assets and that's where the stimulus comes from, not so much in the size of the balance sheet per se."

In effect, the Fed is borrowing from banks to guide capital into Treasuries, government-guaranteed MBS and indirectly into corporate bonds. This Fed-engineered departure from a market-based allocation of capital harms bank lending to other sectors of the economy that would be more likely to create private sector jobs, helping explain the weakness in U.S. GDP growth. The Fed's policies have resulted in a decline in corporate bond yields and greater issuance. However, regulatory policy and capital requirements limit bank leverage, resulting in very slow growth in other forms of credit.

A January 2012 IMF Working Paper reviewing Japan's experience with quantitative easing and portfolio balancing cautioned that: "The evidence on portfolio balancing and signaling, however, was mixed... The impact on economic activity was found to be limited. While some papers suggested that quantitative easing helped create a more accommodative environment for corporate financing and improved the lending attitude of financial institutions, the impact on economic activity and inflation was small. The reason commonly cited was the impaired credit channel due to a weak banking system..."

Injecting Liquidity

In the past, the Fed "injected liquidity" into the private sector by buying Treasury bills from the market when it wanted to loosen monetary policy. It paid by crediting the seller's reserve account at the Fed, which was expected to be used. This added to the M0 monetary base. The private sector then multiplied the new reserves, using them to back multiple bank deposits which were used to fund new loans. Banks with extra lending opportunities could borrow reserves from banks with extra deposits, maximizing the lending from a given Fed injection.

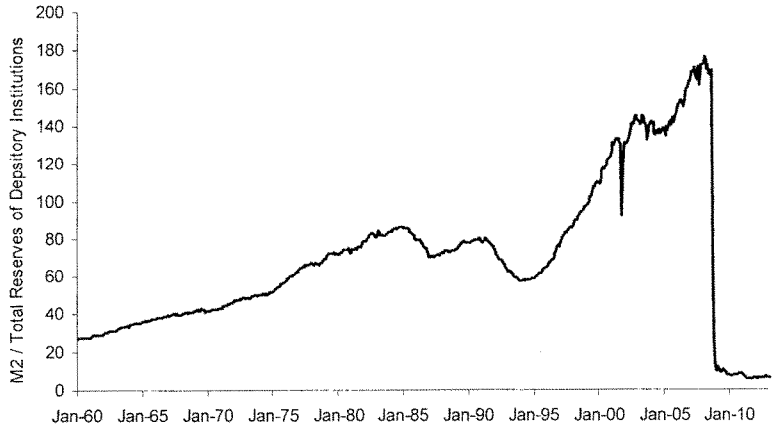
The original injection caused a much bigger increase in the M2 money supply (which includes bank deposits) and usually in private sector credit. The banking system's leverage (the ratio of liabilities to capital) increased as the Fed injected more funds and the regulators permitted more lending. Inflation arose when the Fed injected too much liquidity relative to the output of the economy and regulators allowed more bank leverage. With the advent of floating exchange rates, this weakened the dollar, raised the dollar price of gold and increased nominal prices over time.

Thus, monetary stimulus came from bank reserves being multiplied by bank leverage into bank deposits and bank loans, which in turn added to GDP through the use of credit.

Each part of this chain has been broken. The Fed is creating bank reserves but:

A) The transmission from reserves to M2 is broken;

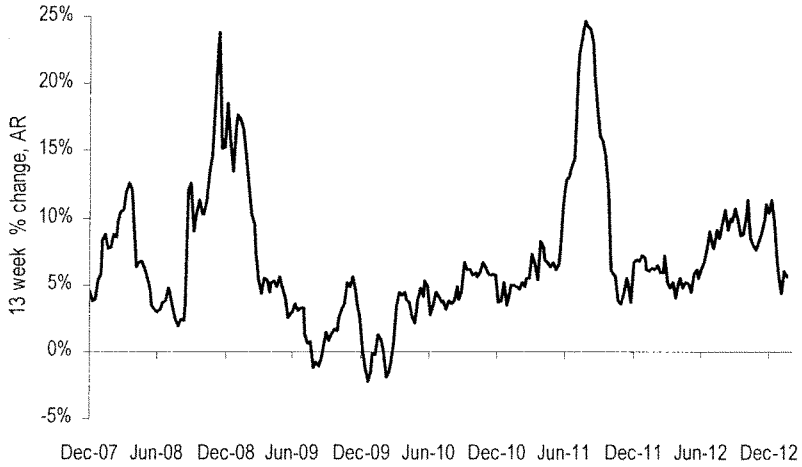
Ratio of M2 to Total Bank Reserves (last obs. January 2013)



Source: Federal Reserve; Encima Global

- The M2 money supply, primarily bank deposits, is at $10.41 trillion. Growth has slowed sharply to a 5.6% annual rate over the last 13 weeks.

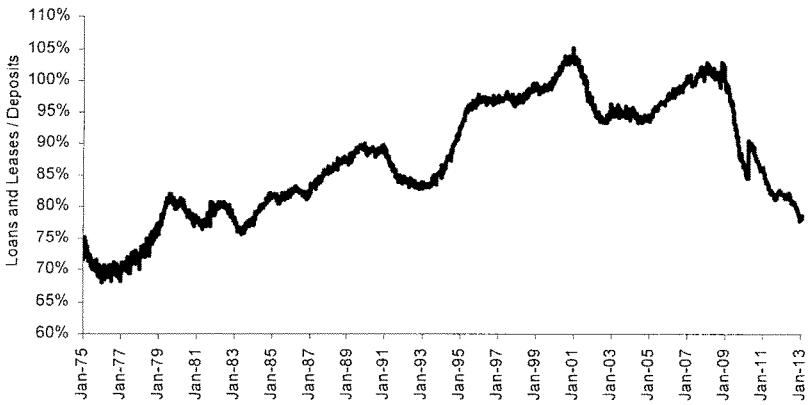
M2 13 Week Annualized change (last obs. February 18, 2013)



Source: Federal Reserve; Encima Global

B) The transmission from M2 and bank deposits to bank loans has broken down, with the ratio of bank loans to deposits down to 78.1%, the lowest since 1984.

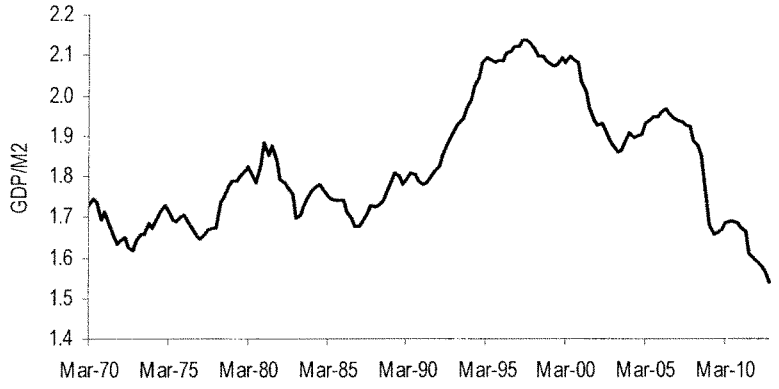
Ratio of Bank Loans and Leases to Deposits (last obs. February 6, 2013)



Source: Federal Reserve; Encima Global

C) The transmission from M2 to GDP is also broken. M2 velocity fell to 1.5 times in the fourth quarter (meaning nominal GDP was only 1.5 times the M2 money supply, down from a 2.1 turnover rate at the peak.) In very rough terms, it used to be that a $1 billion injection of reserves by the Fed allowed an $80-100 billion increase in M2, which would become a $150 billion increase in nominal GDP. This would cause inflation if output and productivity fell behind demand, leaving too much money chasing too few goods.

M2 Velocity – GDP / M2 (last obs. Q4 2012)

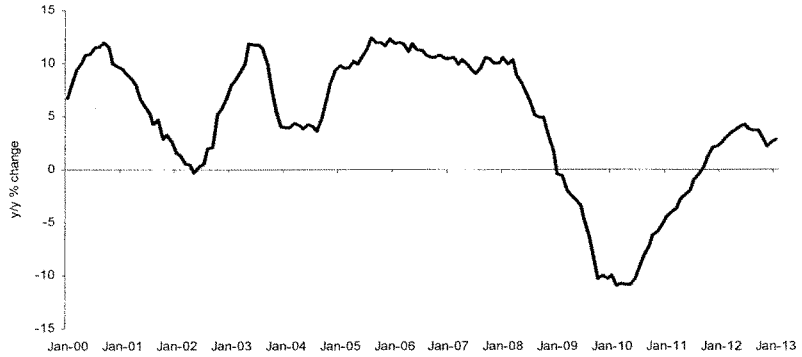


Source: Federal Reserve; Bureau of Economic Analysis; Encima Global

The current system works differently. Over the years, the fractional reserve system changed to a system of direct regulatory control over bank leverage and capital, with sporadic efforts to take risk into account. Rather than the availability of reserves, the binding constraint on a bank's lending activity shifted to the assessment of the bank's leverage ratios and capital adequacy by bank management and government regulators.

In today's environment, the Fed is expanding bank reserves, but their growth isn't connected to private sector bank balance sheets, bank deposits or bank loans, which are barely growing. This was called "pushing on a string" when the Bank of Japan expanded reserves in the 2000s with little positive impact.

Growth in Bank Loans and Leases (break adjusted, y-o-y, last obs. Jan 2013)



Source: Federal Reserve; Encima Global

Conclusion

Under quantitative easing, the Fed has bought trillions of dollars in long-duration bonds, paying for them with short-term interest-bearing reserves borrowed by the Fed. The Fed's balance sheet expanded, but, unlike the old form of liquidity injection, the private sector balance sheet did not increase.

Rather than QE providing stimulus, it is compounding the capital mis-allocation problem by trying to push more credit into corporate bonds.

The Fed is operating as a speculator, borrowing short and lending long while ignoring the conflict of interest this creates when it sets interest rates.

The best exit would be for the government to adopt growth-oriented tax, spending and regulatory policies in parallel with a new growth-oriented Fed resolve to downsize its role in capital allocation and commit to providing a strong and stable dollar. The combination would encourage investment and hiring in the U.S. private sector and would meet the Fed's mandate of maximizing employment by assuring price stability.

On a Path to Crisis

Allan Meltzer Testimony, Subcommittee on Monetary Policy and Trade, March 5, 2013

Our Constitution assigns responsibility for monetary policy to the Congress. The Federal Reserve acts as your agent. The Federal Reserve has expanded bank reserves by more than 350% in the last few years. This is an enormous and unprecedented increase. And it continues.

In my opinion, no entity or agent in our government should have so much unrestrained authority. Current practice violates all our beliefs about checks and balances. It sets a terrible precedent that should be avoided. It carries high costs. And it achieves very limited benefits to our economy.

Many bankers applaud the current, expansive policy. They profit from it because they can borrow from the Fed or in the money market at ¼% or less and lend to the Treasury at 1% or more. They are able to improve their stock prices by paying dividends and increase their incomes by paying bonuses. Does the Congress approve this transfer from taxpayers to the owners and managers of financial firms?

Chairman Bernanke describes the expansive program as on balance of benefit to the economy. I disagree for several reasons.

First, we agree that the low interest rate policy encourages risk taking. But among those increasing their investment risk are retirees who cannot live on the income they receive currently from their usual source of investment, often bank certificates of deposit. Many are said

to seek higher income by investing in emerging market bonds or domestic junk bonds. We know from our history how this practice ends. It ends in losses and tears when interest rates rise, bond prices fall and risky assets default. Or, note what has happened to the prices of farmland, in part a result of the ethanol program that raised agricultural prices. We have seen this pattern of rising farmland prices many times. It has ended in tears and heavy losses many times.

These are examples of a general pattern. Increasingly investors do not want to hold money or low interest rate bonds. They shift into holding equities, raising equity prices and take the risk of holding high yield bonds or claims on farmland, or other risky assets.

Federal Reserve policy is repeating the same mistake that brought us the Great Inflation of the 1970s. Then, and now, the Federal Reserve expanded its balance sheet by financing the government's budget deficits. This time the deficits are larger and the Fed's purchases are much, much larger. And then, as now, the Fed tried to push unemployment rates down. Doing so, they ignore the lesson that Paul Volcker repeated many times: low expected inflation is the way to get low inflation.

We know from that experience and repeated experiences all over the world how highly expansive policy ends. It ends with inflation, followed by a big recession required to end the inflation by reducing money and credit growth and raising interest rates. Ask yourselves, please, what you expect to happen to all the low interest rate bonds that the banks and others hold? Will they all have enough equity reserves to absorb the losses? Or will there be another debt crisis?

The first Federal Reserve balance sheet expansion in 2008 prevented a breakdown of the payments system. That was the right thing to do. The next large balance sheet expansion, called QE 2, added $ 600 billion to bank reserves and the Federal Reserve balance sheet. $ 500 billion went into bank excess reserves. That pays some interest to the bankers but does absolutely nothing for employment and economic activity. Much of the remaining $100 billion went into reserves of foreign central banks. They bought the dollars to limit the depreciation of the dollar against their currency. Other central banks are now expanding reserve growth rapidly. This prevents currency appreciation.

We are now in a third round of QE expansion. Since September bank reserves increased about $ 100 billion dollars. Bank loans to business, called C&I loans, increased a bit during this period, about $ 65 billion—or a modest 5 percent. Again, most of the addition to reserves became idle bank excess reserves. The Federal Reserve pays the banks ¼% on the idle balances they hold at Fed banks.

Why does Chairman Bernanke claim greater benefits than costs? Mainly, he makes the mistake of looking only at interest rates, never mentioning what happens to growth of credit and money. He has kept short-term interest rates near zero and lowered long-term rates. But now long-term rates have started to rise as QE3 gets underway and owners of government and other debt begin to show concern about future inflation. The measure of expected inflation shown in bond yields has moved up steadily for the past six months. It remains low at present but is rising.

Chairman Bernanke assures members of Congress and the public that he has the proper tools to prevent inflation, when it rises. The Fed

proposes to increase the interest rate it pays on the nearly $ 2 trillion dollars of excess reserves. He never tells how high that rate would go and what the increase in all interest rates would do to government spending, output and employment. When that happens, you will want to know. I suggest that you should want to know now.

The United States has an unsustainable budget deficit. Higher interest rates will increase the budgeted cost of servicing our enormous debt. As interest rates rise so do the interest payments on the outstanding debt as the outstanding debt is retired and replaced at higher interest rates. I calculate that 40% of the debt has less than 2 years to maturity. A 3 percentage point increase in rates would increase the budget deficit by about $ 140 billion a year. That cost would rise further as more of the debt is refunded. My estimate does not include the losses on Federal Reserve holdings that reduce the payment of interest income to the Treasury or other interest payments that are not part of direct Treasury debt. Since much of our debt is held abroad, the current account deficit of the balance of payments would rise about $ 40 billion a year.

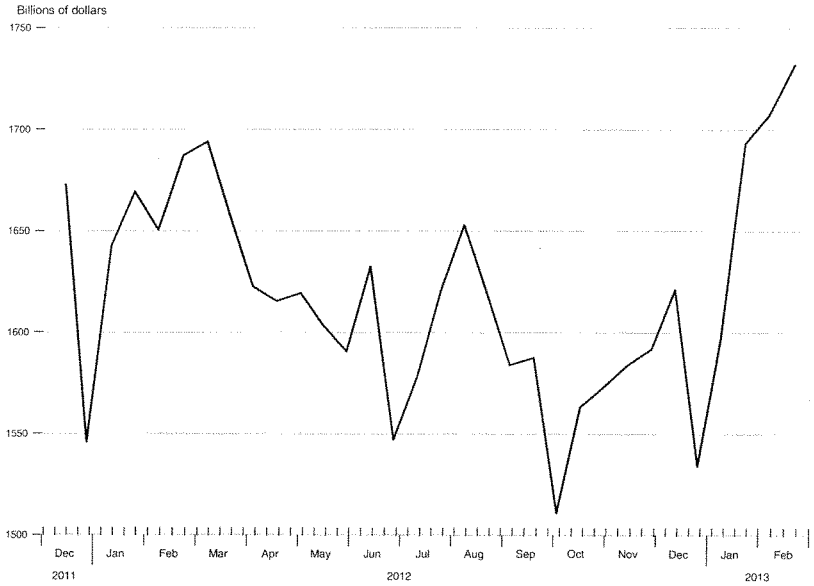
Let me close with this comment. The Federal Reserve will be 100 years old this year. Its history includes only two multi-year periods during which inflation was low, real income and employment fluctuations were modest, and recessions were mild. The two periods are 1923-28 and 1985-2002. In both periods, the Federal Reserve generally followed a monetary rule. In 1923-28 the rule was the gold-exchange standard. In 1985-2002 or 2003, the rule was the Taylor rule.

No rule will be perfect all the time. But the lesson you should draw is that following a rule gives much better results for the public and the

country than policies based on forecasts and judgments. That's a lesson that you should discuss and implement as you consider how to get off the path to crisis and improve on your responsibility for regulating the Federal Reserve and its monetary policy.

Adjusted Reserves

Seasonally Adjusted



Adjusted Reserves

To the average of two maintenance periods ending:	Compounded annual rates of change, average of two maintenance periods ending:							
	02/22/12	05/16/12	07/25/12	08/22/12	09/19/12	10/17/12	11/28/12	12/26/12
07/25/12	-9.6							
08/22/12	-3.9	5.8						
09/19/12	-8.5	-4.5	-5.4					
10/17/12	-11.8	-10.5	-15.8	-33.3				
11/28/12	-6.3	-2.7	-2.1	-10.5	0.7			
12/26/12	-6.4	-3.4	-3.2	-10.0	-1.9	14.5		
01/23/13	-1.5	3.1	5.9	1.4	11.3	28.8	26.1	
02/20/13	3.0	8.8	13.4	10.5	21.1	38.3	41.3	75.1

A Review of Recent Monetary Policy

John B. Taylor[1]

Testimony Before The
Subcommittee on Monetary Policy and Trade
Committee on Financial Services
U.S. House of Representatives
March 5, 2013

Chairman Campbell, Ranking Member Clay, and other members of the Subcommittee on Monetary Policy and Trade, thank you for the opportunity to testify at this hearing on "Near-Zero Rate, Near-Zero Effect? Is 'Unconventional' Monetary Policy Really Working?"

As you requested, my testimony will review the conduct of monetary policy by the Federal Reserve before, during, and after the financial crisis. I will draw on my research and previous testimony.

To be complete such a review must start a decade ago with the period from 2003 to 2005 when the Fed held interest rates very low, which accentuated the housing boom, stimulated risky lending in a search for higher yields, and thereby helped bring on the bust, the defaults and the financial crisis starting in 2007. The review then continues into the financial crisis and recession from late 2007 through early 2009—a period when Fed policy performance was mixed—and concludes with the ongoing weak recovery from the recession in which the Fed's unconventional policy has become a drag on the economy.

A defining characteristic of monetary policy during this decade has been the highly discretionary and unpredictable nature of the changes in the policy instruments, especially in contrast to the steadier rules-based policy of the 1980s and 1990s. The economic outcomes have not been good. Using the Federal Open Market Committee's performance objective, which is "to mitigate deviations of inflation from its longer-run goal and deviations of employment from the Committee's assessments of its maximum level," performance has deteriorated.[2] Deviations of the unemployment rate from the Fed's assessment of the normal rate have increased substantially and inflation deviations have not improved.[3] While this association of outcomes with policy changes does not alone provide evidence of cause and effect, the following testimony presents additional evidence.

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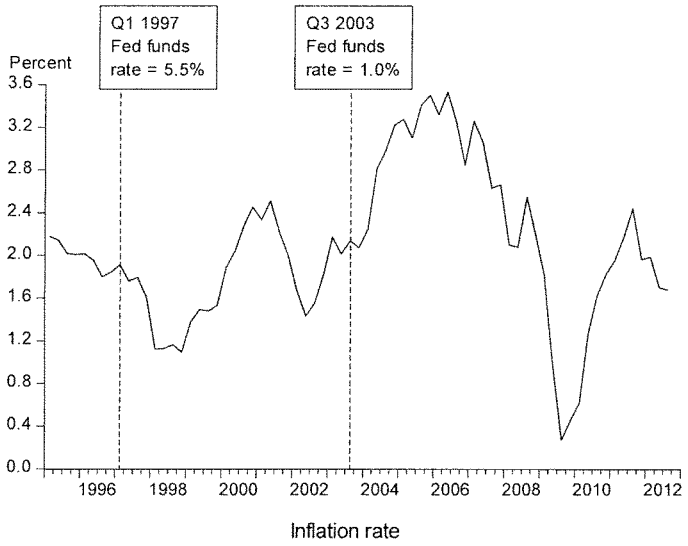
[1] John B. Taylor is the Mary and Robert Raymond Professor of Economics at Stanford University and George P. Shultz Senior Fellow in Economics at Stanford's Hoover Institution.

[2] The criterion is stated in the Federal Open Market Committee's "Statement on Longer-Run Goals and Monetary Policy Strategy" as amended effective on January 29, 2013.

[3] The standard deviation of unemployment from the Fed's 5.6% average normal rate increased from 1.0% during 1984Q1 -2006Q4 to 2.8% during 2007Q1 – 2012Q4 and the standard deviation of inflation was about the same at 0.8 percent in both periods.

1. The Period Leading Up to the Financial Crisis

The Federal Reserve decided during 2003-2005 to hold its target interest rate below the level implied by monetary principles that had characterized monetary policy in the previous two decades of good performance. This decision can be illustrated in the following graph of the overall inflation rate (measured by the GDP deflator) in which I have inserted two boxes showing the level of the interest rate (federal funds) at two different points in time. Observe that the federal funds rate was much lower in 2003 than in 1997, 1.0% rather than 5.5%, even though the inflation rate was about the same, around 2%, during the two time periods, as was the overall state of the economy.



This excessively low interest rate added fuel to the housing boom, which in turn led to the severe housing bust and eventually a sharp increase in delinquencies, foreclosures, and the deterioration of the balance sheets of many financial institutions as toxic assets grew rapidly.

To test the connection between the low interest rates and the housing boom I built an economic model relating the federal funds rate to housing construction. The empirically estimated model showed that a higher federal funds rate would have avoided much of the boom and bust.[4] This policy deviation was larger than any other during the Great Moderation of the 1980s and 1990s—similar in magnitude seen in the unstable period of the late 1960s and 1970s.

[4] See "Housing and Monetary Policy," in *Housing, Housing Finance, and Monetary Policy* Federal Reserve Bank of Kansas City, September 2007, pp. 463-476. Since then there has been much more research which I reviewed in "Commentary: Monetary Policy after the Fall," *Macroeconomic Challenges: The Decade Ahead,* Federal Reserve Bank of Kansas City, 2010, pp. 337-348.

The real interest rate was negative for a very long period, which is also similar to what happened in the 1970s. The intervention was an intentional departure from a policy approach that was followed in the decades before. The Fed's statements that interest rates would be low for a "prolonged period" and that interest rates would rise at a "measured pace" provide evidence of these intentions.

2. *The Financial Crisis and the Panic*

The financial crisis began to flare up in the interbank loan markets in August 2007 but the severe financial *panic* did not start until September 2008. Based on equity price movements and interbank borrowing rates, the panic period lasted through October 2008. It spread rapidly around the world, turning the recession into a great recession.[5]

My assessment is that the extraordinary monetary policy measures taken in the period leading up to the panic in September 2008 did not work, and that some were harmful. For example, the Fed introduced a new Term Auction Facility, but the TAF did little to affect interbank rates during this period, as I testified to the House Committee on Financial Services in February 2008 based on research with John Williams,[6] and it drew attention away from counterparty risks in the banking system. The Fed's extraordinary bailout measures began with Bear Stearns. The Fed's justification for this bailout led many to believe that the Fed's balance sheet would again be available in the case that another similar institution, such as Lehman Brothers, failed. But when the Fed and the Treasury were unable to orchestrate a rescue of Lehman over the weekend of September 13-14, 2008, it surprisingly cut off access to its balance sheet. On the next day, it reopened its balance sheet to make loans to rescue the creditors of AIG. It was then turned off again, and the TARP was proposed. Event studies of the interbank market and equity markets show that the chaotic roll out of the TARP coincided with the severe panic in the following weeks[7].

Evaluating monetary policy once the panic began is complex because the Fed's actions during this period were occurring at the same time as the FDIC issued bank debt guarantees and the Treasury clarified, after three weeks of uncertainty, that the TARP would be used for equity injections. This clarification was a major reason for the halt in the panic in my view. Based on conversations with traders and other market participants as well as on later studies, the Fed's actions taken during the panic were helpful in rebuilding confidence in money market mutual funds and stabilizing the commercial paper market. The Federal Reserve also rebuilt confidence by quickly starting up new lending programs and worked closely with central banks abroad to set up swap lines.

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[5] This section is drawn from my testimony "An Exit Rule for Monetary Policy," before the Committee on Financial Services, U.S. House of Representatives, March 25, 2010

[6] Taylor, John B. and John C. Williams (2008), "A Black Swan in the Money Market," Federal Reserve Bank of San Francisco, Working Paper Series, 2008-04; revised version published in *American Economic Journal: Macroeconomics*, 1 (1), pp. 58-83.

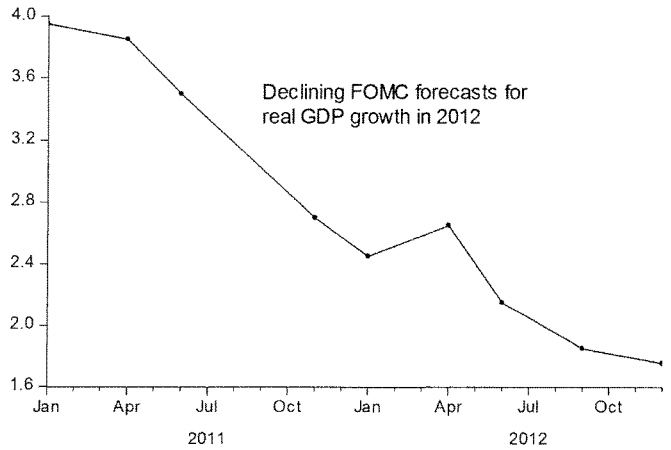
[7] See Taylor, John B. (2008b), "The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong," in *A Festschrift in Honour of David Dodge's Contributions to Canadian Public Policy*, Bank of Canada, November 2008, pp. 1-18

As the panic subsided near the end of 2008 and the recession ended in June 2009, the temporary emergency liquidity facilities, including the swaps, began to be drawn down. However, around this time the Fed started its quantitative easing (QE) programs including the large scale purchases of mortgage backed securities. My assessment, based on research with Johannes Stroebel, is that this initial MBS purchase program had little effect on mortgage rates once one controls for prepayment risk and default risk, but the estimates are uncertain.[8] If it were not for the start of these large-scale asset purchase programs, the Fed would have already exited from its emergency measures removing considerable uncertainty about its exit strategy going forward.

3. Unconventional Monetary Policies and the Weak Recovery

The economic recovery from the recession has turned out to be far weaker than the Federal Reserve expected despite the unconventional policy. In June 2010 the Fed predicted that economic growth would be 4% in 2012, but it has turned out to be a disappointing 1.6%. The forecast range at that time for 2012 was actually from 3.5% to 4.5%, so even the pessimistic views were better than what happened.

The following chart shows how the Fed continuously ratcheted down its forecasts.



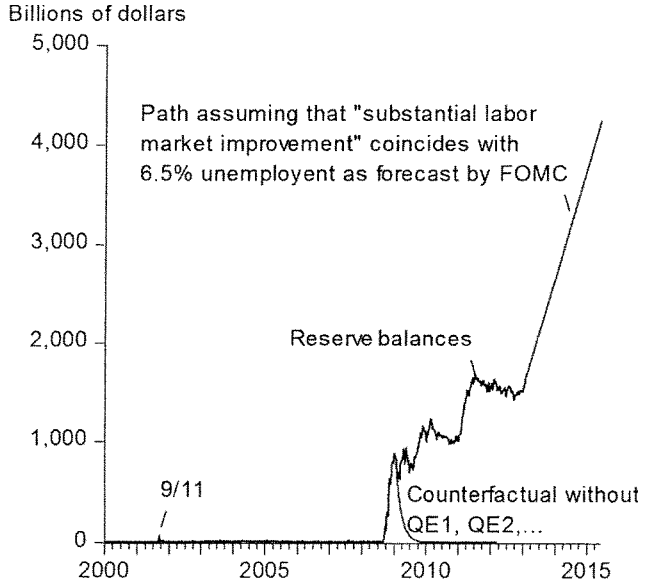
As the recovery fell short of their expectations, the Fed's policymakers increased their unconventional interventions. They increased their purchases of mortgage-backed and U.S.

[8] Johannes Stroebel and John B. Taylor "Estimated Impact of the Fed's Mortgage-Backed Securities Purchase Program," *International Journal of Central Banking*, June 2012. Other studies—for example Joseph Gagnon, Matthew Raskin, Julie Remanche, and Brian Sack (2010), "Large-Scale Asset Purchases by the Federal Reserve: Did They Work?" Federal Reserve Bank of New York Staff Report no. 441, March 2010—argue that the interventions worked, but these studies are based on "announcement effects" which do not incorporate offsetting reverse effects not associated with the announcements.

Treasury securities, and they announced that large-scale purchases would keep coming at a pace of $85 billion per month. They also kept extending the near-zero federal funds rate, and they now indicate that it will remain there at least until unemployment hits 6.5%, which according to the Fed's forecasts will be in mid-2015.

Why have these unprecedented interventions been accompanied by disappointing outcomes? The Fed points to external causes, but the unconventional policies themselves have been a factor. In Congressional testimony last week Federal Reserve Chairman Ben Bernanke pointed to the recent pickup in housing markets as indication that the policy is working, but the steadily disappointing growth performance over four years of these policies is stronger counter evidence.

There are a number of reasons why these policies have been a drag on the recovery. First, the policies create uncertainty. The following chart illustrates this uncertainty. It shows the impact of the Fed's recent actions on the deposits that banks hold at the Fed. The blue line shows recent history and the red line shows a possible future scenario based on the Fed's own statements. When the Fed engages in its current policy of quantitative easing, it finances its purchase of mortgage-backed securities or federal debt by crediting the banks with these deposits. The deposits—called bank reserves—normally are increased during times of financial stress, as on 9/11/2001 as shown in the chart, or during the panic in the fall of 2008, also shown in the chart.



But the huge increases since 2009 are completely unprecedented. The recent Fed decision to buy $85 billion per month until the labor market improves is illustrated by the red line, where I assume that this labor market criterion is the same as its unemployment trigger. In my view it is very risky to continue along this red line. The policy is a drag on the economy in part because people do not know how the bank reserves will be unwound, as they must be eventually.

Recent reports are that these risks are becoming a worry to a number of policy makers at the Fed. People recognize that the Fed will eventually have to undo the interventions and reverse the large-scale asset purchases. If the asset sales are too slow, inflation will rise as bank reserves used to finance the asset purchases flow out of the banks and money growth increases. If the asset sales are too fast or abrupt, there will be a recession as interest rates spike. Those who say not to worry about the interventions because inflation has not increased ignore the fact that the interventions can be a drag on the economy without increasing inflation in the short run.

The Fed's near-zero interest rate also creates problems. It increases incentives for retirees and pension funds receiving miniscule returns to take on risky investments as they search for higher yields. The near-zero rates makes it possible for banks to roll over rather than write off bad loans, locking up unproductive assets. And the low interest rate policy reduces fiscal discipline, which increases the risk of an exploding federal debt.

The excursion of the Fed into fiscal and credit allocation policy through its large scale purchases of Federal debt and mortgage backed securities raises questions about its independence and accountability which reduces public confidence in the Fed. [9] That these policies are being implemented long after the emergency of the panic of 2008 raises legitimate questions about whether the Fed will ever return to the more focused rules-based policy that helped to create growth and stability in the 1980s and 1990s and until recently.[10]

The asset purchases are inherently discretionary and unpredictable because they are so large. While the Fed now says it will continue the large-scale asset purchases until labor markets improve, there is a great deal of speculation about what that means. The quantitative impact of the interventions is very hard to assess and not fully understood by either policy makers or economists. Economic research demonstrates that unpredictable discretionary policy reduces macroeconomic stability. And the on-again off-again purchases have created highly variable money growth.[11]

Moreover, the policy also has potential international ramifications because central banks tend to follow each other as they try to counter sharp appreciations of their currencies. This is what people are now referring to as currency wars. Empirical evidence shows that very low interest rates set by the Fed make it more likely that other central banks will keep their own

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[9] See Allan Meltzer, "What's Wrong with the Fed? What Would Restore Independence?" paper presented at the American Economic Association meetings, January 2013.

[10] See Marvin Goodfriend, "The Elusive Promise of Independent Central Banking," *Monetary and Economic Studies*, Bank of Japan, Vol. 30, November 2012, pp. 39-54 and Otmar Issing, "The Mayekawa Lecture: Central Banks—Paradise Lost," *Monetary and Economic Studies*, Bank of Japan, Vol. 30, November 2012, pp. 55-74

[11] See John B. Taylor "Monetary Policy During the Past 30 Years With Lessons for the Next 30 Years," Cato Annual Monetary Conference, November 2012.

policy rates too low or engage in their own unconventional policy interventions.[12] This creates the risk of commodity booms and busts as we saw in 2011 and 2012.

When dissenters within the Fed and others point out these costs, the majority at the Fed argues that the costs are outweighed by a huge benefit. They argue that the unconventional policies reduce unemployment by increasing aggregate demand, and they back up the argument with macroeconomic models. But these models, which are useful for evaluating conventional monetary policy such as rules for the interest rate, were not designed and are not useful for evaluating unconventional policies.[13] In contrast, a basic microeconomic analysis shows that the policies perversely decrease aggregate demand and increase unemployment while they repress the classic signaling and incentive effects of the price system. [14]

Consider the "forward guidance" policy of saying the short term rate will be near zero for several years into the future. The purpose of this guidance is to keep longer-term interest rates down, and thus encourage more borrowing. A lower future short-term interest rate reduces long-term rates today because portfolio managers can, in a form of arbitrage, easily adjust their portfolio mix between long term bonds and a sequence of short term bonds. If investors are told by the Fed that the short term rate is going to be zero in the future, then they will bid down the yield on the long term bond. The forward guidance keeps the long term rate low and tends to prevent it from rising. Effectively the Fed is imposing an interest rate ceiling on the longer term market by saying it will keep the short rate unusually low.

The perverse effect comes when this ceiling is below what would be the equilibrium between borrowers and lenders who normally participate in that market. While borrowers might like a near zero rate, there is little incentive for lenders to extend credit at that rate. It is much like the effect of a price ceiling in a rental market where landlords reduce the supply of rental housing. Here lenders supply less credit at the lower rate. Even if their interest rate margin appears to be adequate, inherent uncertainty about the course of the short term rate raises risk from such lending.[15] The decline in credit availability reduces aggregate demand which tends to increase unemployment, a classic unintended consequence of the policy. Empirical research consistent with this view shows that during periods of forward guidance, the long term interest rate does not adjust to events that shift supply or demand as it does in normal periods.[16]

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[12] John B. Taylor, "International Monetary Coordination and the Great Deviation," paper presented at the American Economic Association Annual Meetings, January 2013

[13] Since the 1970s I have been actively engaged along with many other economists in building such models for the purpose of evaluating monetary policy rules at central banks. Many of the models have been archived by Volker Wieland in his Macroeconomic Model Data Base at the University of Frankfurt. The models involve some form of price and wage rigidity through which monetary policy affects the real economy as well as expectations assumptions for longer term interest rates and other variables. But such models have not included ways to evaluate the impact of quantitative easing on interest rates, nor, of course, have they been tested for unprecedentedly long near-zero interest rate policy. Ronald McKinnon emphasizes in his "When Is a Monetary "Stimulus" Not a Stimulus?" Stanford Institute for Economic Policy Research, Policy Brief, February 11, 2013 that the models do not incorporate the perverse impacts of the near-zero rate policy on financial intermediation.

[14] This part of the testimony is drawn in part from my *Wall Street Journal* article, "Fed Policy Is a Drag on the Economy," January 28, 2013.

[15] See Peter Fisher, "Bernanke Runs the Risk of Creating a Liquidity Effect," *Financial Times*, September 10, 2012.

[16] Eric T. Swanson and John C. Williams "Measuring the Effect of the Zero Lower Bound on Medium- and Longer-Term Interest Rates," paper presented at the American Economic Association Annual meetings, January 2012

Conclusion

In answer to the questions raised for this hearing, this testimony argues that the Fed's unconventional monetary policy is not really working. Of course, this is contrary to the Fed's stated intentions as presented to the Financial Services Committee by the Chairman of the Federal Reserve. Ironically the ineffectiveness of these interventions and the disappointing economic performance during the weak recovery has led policy makers to intervene more. No one should want a continuation of this vicious circle. If the economy improves this year, perhaps the Fed will slow or halt its asset purchases and clarify its intentions to return to conventional policy in the future. In my view this will help to bolster growth and in turn result in fewer interventions in a virtuous circle that helps put the economy on a strong sustained recovery path.