Progress and Promise for Monetary Policy Reforms

Andy Barr

Today we are turning the corner on monetary policy. We will soon have a new Federal Reserve Board chairman and could, in an important sense, have an entirely new Board of Governors before too long. We are excited about what this prospective change in personnel can bring in terms of more reliable policy for American economic opportunities. But we are not waiting for personnel changes in the Eccles Building to further our own monetary policy changes from the Hill.

Effective personnel are important. But even the best Fed governors cannot do right by our economy without political-legal institutions that reliably support competitive trade wherever it might lie. Recently we took an important step to improve the rules of the game for both our monetary policymakers and Congress. We marked up three bills that will (1) reduce growth-killing uncertainty that continues to undercut the efficacy of our monetary policies; (2) sweep out the Fed's growth-killing balance sheet distortions; and (3) stop relying on the Fed to spend money that we do not have, and start holding Congress accountable for America's credit policy.

Cato Journal, Vol. 38, No. 2 (Spring/Summer 2018).

Andy Barr is U.S. Representative for Kentucky's Sixth Congressional District, which he has been serving since January 2013. He is a member of the Committee on Financial Services and Chairman of the Monetary Policy and Trade Subcommittee. This article is based on the author's remarks at the Cato Institute's 35th Annual Monetary Conference on November 16, 2017.

As the legislative process moves forward, we are motivated by the simple truth that, if monetary policy does not work, then our economy cannot work. We know that some forms of monetary policy are clearly better than others. Throughout history, a number of commodities have served as money. Even stone wheels at the bottom of the Pacific Ocean have been respected as a legitimate exchange medium.

And imagine the exchange medium that people might have used not too long ago where we sit today. Certain types of tobacco leaves could have served as money, and we would have spent more time and effort examining whether a particular leaf would reliably store value than we would enjoying that value. The high cost of transacting itself would have slowed or altogether stopped markets from helping goods and services (which include labor) find their most promising opportunities.

Monetary policy can appear complicated, but unless we appreciate its foundational role in producing and delivering the economic opportunities that can and should be readily available across our country, we will continue to fall short of our true potential. Our work on the Committee is dedicated to making sure that does not happen.

Two years ago, my colleague on the House Financial Services Committee, Representative Bill Huizenga of Michigan, spoke at this conference on the eve of our Fed Oversight Reform and Modernization Act or FORM Act. Shortly thereafter, my colleagues and I passed that legislation through the full House of Representatives. This time, we have a chance to move our legislation even further. Our goal now is not only to move a solid set of monetary policy reforms out of the House, but also to place it on President Trump's desk for signature.

Motivation for and Details of Markup Bills

We marked up three reforms that are strong on policy and capable of attracting both deep and broad support. We started by introducing a simple but important strategy to improve how the Fed communicates monetary policies.

Monetary Policy Strategy

Better communication may sound boring. But it is key to reducing growth-killing policy uncertainty that, according to recent Fed

research, creates a significant drag on our economy.[1] Our legislation brings greater transparency to how monetary policy reacts to economic changes so that households and businesses have the information they need to make productive decisions.

The Federal Open Market Committee (FOMC) characterizes its conduct of monetary policy as "data dependent." In doing so, however, it leaves households and businesses uncertain about *what data matter* and *how they matter*. By providing for the annual adoption of a monetary policy strategy of the Fed's own choosing, as well as a small set of reference policy rules, our legislation will reduce that uncertainty and provide more reliable and stronger support for a dynamic economy.

During our Committee's last Humphrey–Hawkins hearing,[2] Federal Reserve Board Chair Yellen expressed interest in working with our Committee to codify a simple and effective framework for a more transparent and accountable monetary policy. By adopting the best of proposals from both sides of the aisle, this framework promises to reliably support a stronger economy that works for everyone. Testifying before our monetary policy subcommittee, economist Joseph Gagnon from the Peterson Institute shared the following observation: "The best strategy is for the Fed to use various rules in assessing the stance of policy. Whenever it deviates noticeably from popular rules, the Fed should explain clearly why it is doing so."[3] Our Monetary Policy Transparency and Accountability Act provides for exactly the type of framework that Gagnon and other highly regarded witnesses from both sides of the aisle have advocated during our extensive hearings.

Moving this legislation into law is essential to minimize growth-killing uncertainty and reliably support the kind of economic

[1]A recent study by Federal Reserve Board economists finds that "positive shocks to uncertainty about monetary policy robustly raise credit spreads and reduce output" (Husted, Rogers, and Sun 2017).

[2]Full-Committee hearing entitled "Monetary Policy and the State of the Economy" (July 12, 2017). Available at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=402098.

[3]Monetary Policy and Trade Subcommittee hearing entitled "The Fed Turns 100: Lessons Learned over a Century of Central Banking" (September 11, 2013). Quoted from page 11 of the printed hearing, available at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=347585.

dynamism that each of our diverse constituencies needs to engage the opportunities they deserve.

A Monetary Policy Balance Sheet

In addition to reducing policy uncertainty, we also address the Fed's distortionary balance sheet. We do so by establishing a Fed-Treasury asset swap—one that will transfer unconventional assets to the Treasury in exchange for an equally valued set of Treasury securities. Almost half of today's Federal Reserve balance sheet continues to reflect the Fed's emergency expedition into favoring some asset prices at the expense of others.[4] In addition to creating asset price distortions, continuing this expedition increases threats to monetary policy independence. Our asset swap facility sets the ship straight, leaving the Fed with the assets it needs to conduct monetary policy and requiring our government's fiscal principals to manage credit-related assets.

As I mentioned earlier, an efficient monetary policy helps goods and services readily find their most promising opportunities. To be sure, realizing this ideal is hard, even under favorable conditions. It becomes harder still when central banks step beyond their monetary policy role and into the political realm of favoring some credit prices over others (as the Fed has done, for example, by purchasing almost $2 trillion of mortgage backed securities during and after the financial crisis).[5]

Economists of different stripes shared considerable concerns with our Committee about this unfortunate development. Testifying as a minority witness before our monetary policy subcommittee, MIT economist Simon Johnson observed that "we're all agreeing . . . that fiscal policy infrastructure is the responsibility of the fiscal authority, which is that Congress in the United States . . . it is not the responsibility, and should not become the responsibility of the Federal Reserve."[6]

[4]Federal Reserve Statistical Release (H.4.1), "Factors Affecting Reserve Balances" (October 26, 2017). Available at www.federalreserve.gov/releases/h41/current/h41.htm.

[5]As of October 26, 2017, the Federal Reserve Banks own almost $1.8 trillion of federal agency debt securities and mortgage backed securities. See www.federalreserve.gov/releases/h41/current/h41.htm.

[6]See the Monetary Policy and Trade Subcommittee hearing entitled "Unconventional Monetary Policy" (December 7, 2016). Available at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=401201.

Our Independence from Credit Policy Act promotes a more resilient financial system *and* more productive allocation of credit. It provides for an orderly return of the Fed's balance sheet to, as Chair Yellen has described, "a primarily treasury-only portfolio."[7]

Congressional Accountability for Emergency Credit Facilities

Finally, our Committee voted out a framework for congressional approval of emergency lending. Time and again, Americans have watched their Federal Reserve stretch its mandates beyond the breaking point, with the predictable result of increased financial fragility and decreased economic opportunity.

Politicians and advocacy groups from both sides of the aisle agree that doing better requires a brighter line between conventional monetary policy and emergency credit policy. Following the introduction of Warren-Vitter, the president and CEO of Better Markets, Dennis Kelleher, warned:

> While the much smaller $700 billion TARP program received widespread scrutiny, the Fed's trillions in bailouts did not. In fact, the public and even its elected officials in Congress were mostly kept in the dark about these bailouts. That was wrong. The Dodd-Frank Wall Street Reform and Consumer Protection Act made some modest changes to limit the Fed's ability to bailout Wall Street in the future, but more needs to be done if taxpayers are to be protected, bailouts are to be limited, too big to fail is to be ended and market discipline is to apply to Wall Street like the rest of America's banks and businesses [Kelleher 2015].

By drawing a bright line of accountability between monetary and credit policy, our Committee's Congressional Accountability for Emergency Lending Act provides for both a more productive monetary policy and a less distortionary credit policy. Moreover, it does so in a manner that Americans for Financial Reform characterized as aligning "not only with the intent of the Dodd-Frank Act, but with traditional principles of central bank lending that go back centuries."[8]

[7]Full-Committee hearing entitled "Monetary Policy and the State of the Economy" (July 12, 2017). Available at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=402098.

[8]Quoted from Warren (2015).

Moving Forward

Ambitious for sure, our work from this week has a few more miles to travel. We hope you will join us for the ride. Our detractors persist with the mantra that, except for the Fed's great monetary distortion, our economy would have fallen into another Great Depression. According to them, we should be thanking the Fed, not reforming it.

It is true that our economy is performing better than many. But "better than many" is the wrong metric for America and Americans. The right metric is whether we are performing as strongly as we can. The fact that our recovery has been considerably weaker than previous post-war recoveries tells us that we are not living up to our potential (Federal Reserve Bank of Minneapolis 2017).

Macroeconomic Orthodoxy vs. Sound Monetary Policy

As we dig out of this hole—and the past two quarters of 3 percent growth are a promising start—our efforts will be more effective by understanding how we got here. We got here, unfortunately, by asking more from our monetary policy than it can possibly deliver.

Some of you remember the Rock & Roll Hall of Fame band, Jefferson Starship. One of their hit songs includes the line "if only you believe in miracles . . . we'd get by." A catchy tune, for sure, but monetary policies should not rely on believing in miracles. Year after year, the oracles of macro and money told us that the promises of unconventional policies are coming soon. Almost a decade out of the financial crisis, we are done waiting!

The legislation we are moving through Congress builds on a foundation of local knowledge and individual incentives—fundamentals that have disappeared from too many of our policy discussions. The oracles of macro and money instead apologize that our best days are behind us. They tell us that their seat-of-the-pants response to the Great Recession has nothing to do with an economy that only recently started showing signs of life—over eight years post-recession.

Today we enjoy the most remarkable technologies that human kind has known. But the oracles continue to tell us our best ideas are behind us. They say that today's breakthroughs represent only marginal advances on historically seminal innovations. They tell us we should not expect to see seminal innovations repeated.

With his book on *The Rise and Fall of American Growth*, Northwestern University economist Robert Gordon gained

prominence for this neo-Malthusian outlook.[9] According to Gordon, America's remarkable economic boom from the 1870s to the 1940s was a one-off event (Krugman 2016). The professor is not alone in peddling such a dismal outlook. Spinning such yarns has become a thriving business for popular economists. Consider Lawrence Summers' reincarnation of "secular stagnation" theory. According to the former Harvard president and Treasury secretary, we "suffer from an imbalance resulting from an increasing propensity to save and a decreasing propensity to invest" (Summers 2016). As a consequence, the so-called natural rate of interest has fallen so low that conventional monetary policy has little if any room to work its Keynesian magic.

Viewed through this lens, today's economic lethargy appears normal. According to the oracles, we should sing halleluiah for unconventional monetary policy and fiscal deficits as far as the eye can see. Except for these measures, they tell us, the new normal would be even worse. But this emperor has no clothes. Today's oracles look to highly aggregated data for policy information, despite those data having little if anything to do with economic fundamentals. Boilerplate policy responses to economic anemia have thus become repeated exercises in goosing consumption, investment, or government spending.

By ignoring that macro performance depends on micro decisions, models like those referenced by the oracles presume a supernatural capacity to optimally control the most complex of systems—our economy. But just as businesses cannot continually hide mismanagement behind financial engineering, governments cannot create true prosperity by opportunistically diverting scarce resources into politically favored national income accounts.

Setting the Ship Straight

My colleagues and I in the House have a better way. Consider what you would have lived through during what Professor Gordon characterizes as our golden age. You would have endured Reconstruction following the Civil War, lynchings, economic

[9]The prominent *Wall Street Journal* columnist, Greg Ip, is also promoting this hypothesis (Ip 2016).

depressions, and world wars—and major banking crises at a rate of more than once-per-decade.[10] If people living under those conditions produced a remarkable economic expansion, then we can surely find a better way today.

Instead of throwing up our hands in response to Professor Gordon's treatise, we should get to the bottom of why we are not fulfilling our potential. The answer lies with missing policies for economic opportunity—those that build on clearly defined property rights and institutions for competitive markets. The contrast between this framework for efficiency and those that motivate the above-described orthodoxy could not be greater.

Today's oracles of money and macro depend more on imagination than sound economic principles. They tell us that, were it not for unsustainable deficits and unconventional monetary policies, our economy would be falling even further from its potential. Given that neither logic nor evidence stands on their side, perhaps they should embrace a strategy along the lines of Seinfeld's George Costanza—"do the opposite" of what tried and untrue Keynesian instincts dictate.[11]

A better way builds from *why* we find ourselves in this unacceptable environment. The natural rate of interest, which enjoys frequent reference without reliable understanding, simply refers to the price of credit that emerges from competition between borrowers and savers. But when distortionary monetary and economic policies sow pessimism instead of promise, people curb investment and consumption to save more, and thus drive the natural rate toward zero.

Loosely grounded policies that promised economic liftoff left us grounded in an economic fog. Notice that these policies are effectively based on contradictory premises—that is, clear price signals give households and businesses the information they need to make productive economic decisions in normal time; but, in times of

[10]Americans saw major banking crises in 1873, 1884, 1890, 1893, 1896, 1907, the 1920s, and 1930–33 (see Calomiris and Haber (2014: 5).

[11]During the fifth season of the sitcom Seinfeld, the hapless character George Costanza has a revelation. Recognizing that every decision he ever made was wrong, George commits to doing the opposite of what his demonstrably failed instincts would have dictated.

turbulence, we should stop believing in physics and start believing in animal spirits. In other words, we are supposed to believe that monetary distortions are a reliable antidote to economic distortions.

Even more worrisome, others think we can fool all of the people all of the time. These economists founded the "QE [quantitative easing] forever caucus," and repent for our sins by pointing to an outsized balance sheet that lets the Fed make outsized Treasury remittances. Remarkably, the Fed continues to embrace this story, ignoring the risks inherent in such a carry trade. If public companies played this game of non-disclosure, they would be getting regular calls from the SEC or worse. Pretend money will never cure our fiscal problems, and it cannot support the kind of economic dynamism that American households and businesses are fully capable of producing.

Almost a decade out from the Great Recession, returning to a more reliable monetary policy is long overdue. Monetary policy distortions helped us get into the recession. More of the same will not bring a stronger recovery.

Remember what Milton Friedman said in his 1967 presidential address to the American Economic Association:

> We are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve, and as a result, in danger of preventing it from making the contribution that it is capable of making [Friedman 1968: 5].

Conclusion

I agree with Milton Friedman: monetary policy needs to return to doing what it can and only what it can—that is, consistently producing an efficient exchange medium so that real goods and services (which include labor) can freely engage their most promising opportunities. The legislation we passed out of Committee does just that, by reducing policy uncertainty, facilitating an orderly exit from distortionary Fed credit policies, and holding Congress to account for risking taxpayers' money through emergency loans. I look forward to advancing these bills through Congress and introducing complementary legislation in the not too distant future.

References

Calomiris, C. W., and Haber, S. H. (2014) *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit*. Princeton, N.J.: Princeton University Press.

Federal Reserve Bank of Minneapolis (2017) "The Recession and Recovery in Perspective." Available at www.minneapolisfed.org/publications/special-studies/recession-in-perspective.

Friedman, M. (1968) "The Role of Monetary Policy." *American Economic Review* 58 (March): 1–17.

Husted, L.; Rogers, J.; and Sun, B. (2017) "Monetary Policy Uncertainty." International Finance Discussion Papers No. 1215. Available at https://doi.org/10.17016/IFDP.2017.1215.

Ip, G. (2016) "The Economy's Hidden Problem: We're Out of Big Ideas." *Wall Street Journal* (December 6): 5.

Kelleher, D. (2015) "Better Markets Statement on the Introduction of the Bailout Prevention Act" (May 13). Available at https://bettermarkets.com/newsroom/better-markets-statement-introduction-bailout-prevention-act.

Krugman, P. (2016) "Paul Krugman Reviews 'The Rise and Fall of American Growth' by Robert J. Gordon." *New York Times Book Review* (January 25).

Summers, L. H. (2016) "The Age of Secular Stagnation: What It Is and What to Do about It." *Foreign Affairs* (February 15).

Warren, E. (2015) "Warren, Vitter Introduce Bailout Prevention Act." Press Release (May 13). Available at www.warren.senate.gov/?p=press_release&id=818.