**A NEW MISSION FOR THE FED**

Remarks by U.S. Representative Kevin Brady,
Vice Chairman of the Joint Economic Committee
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Kevin (Hassett), thank you for hosting this forum today and for the great work the American Enterprise Institute performs in a variety of key areas dealing with the American economy, fiscal and monetary policy and our free enterprise system. I also thank the panelists today, each of bring to this discussion experience, insight and perspective.

Looking to our economic future, Washington should have one goal: ensuring that America has the world's strongest economy throughout the 21st century.

We can't assume that our economic preeminence will continue any more than Britain could at the close of the 19th century. Some pessimists suggest that dominance is now passing to China. I reject that notion.

However, to ensure the 21st century is another American century, we must renew our commitment to what works well—our free market system—and reform what does not—our federal government.

In the context of a strong economic future for the next 100 years, we must thoughtfully and clearly define the role of the Federal Reserve.

In my view a sound dollar is the sure and strong foundation for long-term economic growth. A sound dollar creates certainty and facilities new business investment and long-term job creation. Therefore, the focus of the Federal Reserve should be protect the purchasing power of the dollar by maintaining price stability.

Are there other fundamentals America must get right to retain our economic standing in the 21st Century? Of course. Congress and the president must:

- Make our tax system simpler and more internationally competitive by lowering marginal tax rates, moving to a modern territorial system and eliminating distortions that pick winners and losers within our free market.
- Reform Social Security, Medicare, and Medicaid to make them sustainably solvent;
- Transform our regulatory system so that we can achieve our common goals—including a clean environment and safe workplaces—in more efficient, balanced, and less destructive ways; and

- Pursue trade agreements to open foreign markets and sell more American goods and services to the 95% of the world's population that lives outside of our borders.

However, these reforms by themselves will be insufficient if the Federal Reserve fails to maintain the purchasing power of the dollar over time. That is why we must first examine what monetary policy should be going forward.

Economists broadly agree that the best way for a central bank to help maximize real economic growth and job creation is to maintain stable prices over time. One need only look to the Great Depression of the 1930's and the Great Inflation of the 1970's to see that both price deflation and price inflation are destructive. Both reduce real output and employment below what they would have otherwise been. Thus, the goal of monetary policy should be long-term price stability.

In 1977, Congress mandated that the Federal Reserve pursue monetary policy "so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."[1] Since inflationary expectations affect long-term interest rates, the goals of stable prices and moderate long-term interest rates are interrelated. This is why the Federal Reserve is described as having a dual mandate for both price stability and maximum employment.

The employment half of the dual mandate reflected the *Employment Act of 1946*[2] required the federal government to pursue economic policies that "promote maximum employment, production, and purchasing power." The price stability half of the dual mandate reflected rising public concerns about price inflation in the 1970's.

When thinking about the Federal Reserve's dual mandate, it is important to remember an observation made by Nobel Laureate economist Robert Mundell: To achieve a policy outcome, you must use the right policy lever.

In the Federal Open Market Committee (FOMC) statement of January 25, 2012, Chairman Ben Bernanke and the other members recognized that monetary policy is the right lever to maintain the purchasing power of the dollar by declaring, "The inflation rate over the longer run is primarily determined by monetary policy." In contrast, the FOMC acknowledged that monetary policy is the wrong lever to promote job creation by declaring "[t]he maximum level of employment is largely determined by nonmonetary factors."

Congress delegates monetary policy to the Federal Reserve and should hold it accountable for its conduct of monetary policy. However, it makes no sense for Congress to charge the Federal Reserve to control what it cannot. Except in the very short term, monetary policy can't boost real output and job creation. Instead, using monetary policy as a short-term tool to speed growth may actually harm the economy.

Ultimately, it is the President and Congress, not the Federal Reserve, that control the budget, tax, and regulatory policies that create the business climate which drives economic growth and job creation. There is no substitute.

Since Congress gave a dual mandate to the Federal Reserve, governments in many other countries have revised the charters of their central banks. In most cases, these governments gave their central bank either a single mandate for price stability or a primary mandate for price

stability with other goals clearly subordinated. Among the 47 central banks and monetary authorities in major countries surveyed by the Bank for International Settlements, only the Bank of Canada and the Federal Reserve have organizational laws that give other goals equal weight to price stability.[3]

So how should the Federal Reserve pursue its mandate? According to Stanford University economist John Taylor, the choice is between a discretionary regime and a rules-based regime. A discretionary regime generates uncertainty because it relies upon the subjective assessments of central bank policymakers. In contrast, a rules-based regime reduces uncertainty because it follows well-established rules, based on observable economic data, with a clear focus on a long-term goal.

Inflation-targeting is a rules-based regime, under which a central bank establishes a target inflation rate expressed in terms of a broad-based price index of goods and services. A central bank tightens monetary policy when the actual inflation rate rises above its target and loosens monetary policy when the actual inflation rate falls below its target.

The last four decades of U.S. monetary policy demonstrate the advantages of a rules-based regime over a discretionary regime. During the 1970's, the Federal Reserve had "go-stop" policies in which monetary policy quickly swung from ease to tightness and back again. This incoherence produced a highly volatile real economy and rising inflation.

A sea change occurred with the appointment of Paul Volcker as Chairman of the Board of Governors of the Federal Reserve in 1979. Under Volcker, the FOMC tackled price inflation by controlling the growth of the money supply. This successful strategy was a significant step toward a rules-based monetary policy. While the economy did suffer back-to-back recessions (January 1980 to June 1980 and July 1981 to November 1982), inflation as measured by the consumer price index dropped dramatically from 13.3 percent in 1979 - the year Volcker joined the Federal Reserve - to 3.8 percent in 1982.

However, between 1983 and 2000 - the period known as the Great Moderation - the Federal Reserve pursued price stability through an increasingly rules-based monetary policy, effectively ignoring the second half of its mandate. Two long economic booms resulted, with very low inflation. The booms were interrupted only by a short, shallow recession related to the First Persian Gulf War.

Between 2002 and 2005, the FOMC deviated from this successful rules-based regime, moving to a discretionary regime by keeping interest rates too low for too long. This loose monetary policy contributed to the inflation of an unsustainable housing bubble that eventually triggered a global financial crisis.

Since the height of the financial crisis during the fall of 2008, Washington has increasingly relied on the Federal Reserve to take unusual, interventionist actions such as tripling the size of its balance sheet under QE1 and QE2 by purchasing the debt and residential mortgage-back securities (RMBS) issued by Fannie Mae and Freddie Mac as well as Treasuries. Indeed, the FOMC justified these extraordinary actions by invoking—for the first time ever in late 2008—the employment half of the Federal Reserve's dual mandate.

Ultimately, the FOMC took these actions to compensate in part for President Obama's failure to pursue pro-growth budget, tax and regulatory policies. They may well continue because just as low borrowing costs are masking the pain of historically high federal budget deficits, the Federal Reserve's monetary experimentation continues to permit the White House and Congress to shirk their responsibility for creating a competitive business climate.

The Federal Reserve's monetary experimentation of the last decade must end. Congress should give the Federal Reserve a single mandate for price stability, and the Federal Reserve should return to a rules-based system of inflation targeting to achieve that mandate.

To provide the foundation for long-term economic growth for American, today I am unveiling the *Sound Dollar Act.* It reforms the Federal Reserve in several important ways. Specifically, the *Sound Dollar A*ct replaces the dual mandate with a single mandate for long-term price stability; increases the Fed's accountability and openness; diversifies the Federal Open Markets Committee; ensures credit neutrality for future Fed purchases and institutes congressional oversight of the Consumer Financial Protection Bureau (CFPB).

Critics of a single mandate often charge that focusing on a sound dollar implies the Federal Reserve will ignore the employment needs of Americans. It's just the opposite. America can only maximize its real economic output with long-term price stability. Thus, protecting the purchasing power of the dollar provides the strongest foundation for lasting economic growth and job creation.

A mandate for price stability gives the Federal Reserve the right goal, but does not alone ensure that the Federal Reserve achieve price stability. That requires the Fed to move away from a discretionary regime and back toward a rules-based regime.

In January 2012, the FOMC announced an inflation target of 2% defined in terms of the price index for personal consumption expenditures. I strongly applaud Chairman Bernanke and the other members of the FOMC for this step toward a rules-based, inflation-targeting regime.

However, this is merely a policy statement that could be reversed. Therefore, the *Sound Dollar Act* mandates that the FOMC continue inflation targeting.

As you know, accurately measuring inflation is not easy. In the last decade, we clearly saw that price indices of goods and services don't always record all of the price movements in our economy, allowing asset bubbles to inflate undetected. The FOMC's inflation target relies upon the price index for personal consumption expenditures. However, this index shouldn't be the sole indicator the Federal Reserve uses for measuring inflation. To identify incipient asset bubbles before they inflate to dangerous levels, the *Sound Dollar Act* requires that the FOMC also monitor:

(1) The prices of and returns on broad classes of assets including equities, corporate bonds, state and local government bonds, agricultural real estate, commercial and industrial real estate, and residential real estate;

(2) The price of gold; and

(3) The foreign exchange value of the U.S. dollar.

To be clear the *Sound Dollar Act* doesn't prescribe any specific action that the Federal Reserve must take if it detects an asset bubble. The appropriate response is highly dependent upon circumstances. These responses might include a tightening of monetary policy, supervisory suasion, and regulatory actions to reduce the flow of credit to fund purchases of the asset. Discretion with respect to the best response should be left to the FOMC. However, identifying an asset price bubble early may help to avoid the overinvestment and the malinvestment that must eventually be liquidated at a heavy cost in terms of lower real output and lost jobs.

Let's turn to the Federal Open Markets Committee. As important as they are, there is more to the U.S. economy than Washington and New York. To broaden input, increase geographic diversity and reduce the overwhelming influence of New York and Washington into FOMC decision-making, the S*ound Dollar Act* grants a permanent seat on the FOMC to every regional Federal Reserve Bank president. Currently, only the Governors and the President of the Federal Reserve Bank of New York have permanent seats. Four of the remaining 11 presidents rotate on and off the FOMC each year. Implementing this change restores the original intent of Congress to establish the Fed as representative of a broad cross section of America's diverse economy.

I am firmly committed to the independence of the Federal Reserve in conducting monetary policy. That's why I am particularly troubled by the FOMC decision in September 2011 to reinvest the proceeds from maturing federal agency debt and RMBS into new federal agency RMBS instead of allowing these holdings to decline as originally intended. This policy reversal occurred amid intense pressure from special interest groups for federal actions to support the ailing housing market.

When the FOMC deals in securities other than Treasuries, repurchase agreements, and reverse repurchase agreements for the System Open Market Account, the Federal Reserve is allocating credit among different sectors of our economy. Credit allocation exposes the Federal Reserve to political interference. To maintain the independence of the Federal Reserve and to ensure credit neutrality, the *Sound Dollar Act* requires the FOMC to deal only in Treasuries, repos, and reverse repos for the System Open Market Account unless the FOMC finds by a 2/3 vote that "unusual and exigent circumstances" exist. The FOMC could then purchase other securities for the System Open Market Account so long as they are liquidated within five years after end of the "unusual and exigent circumstances."

Looking ahead to the next crisis, it's important to note that in nearly a century of existence, the Federal Reserve has never articulated its lender-of-last-resort policy. Economist Allan Meltzer describes the problems this void creates:

> *The absence of a [lender-of-last-resort] policy has three unfortunate consequences. First, uncertainty increases. No one can know what will be done. Second, troubled firms have a stronger incentive to seek a political solution. They ask Congress or the administration for support or to pressure the Federal Reserve or other agencies to save them from failure. Third, repeated rescues encourage banks to take greater risk and increase leverage. This is the well-known moral hazard problem.*[4]

Each of these problems became manifest in 2008. To avoid these problems in the future, the *Sound Dollar Act* requires the Federal Reserve to publish its lender-of-last-resort policy. Of course, we do not expect a precise tactical plan. As President Dwight D. Eisenhower observed, "War plans never survive the first battle; nevertheless, war planning is essential for victory." Similarly, while the Federal Reserve cannot anticipate every nuance of the next financial crisis, publishing a lender-of-last-resort policy will reduce future market uncertainty.

Next, I applaud Chairman Bernanke for his steps to increase transparency in monetary policy decision-making, but there is an additional step that the Federal Reserve should take. The *Sound Dollar Act* speeds the release of transcripts of FOMC meetings from five years to three years. Some critics claim this acceleration would inhibit free discussion at FOMC meetings. If that is true, then we need different FOMC members. A three year lag will also allow Congress to review these FOMC transcripts before a Fed Chairman is reconfirmed – which is absent from the deliberations today.

In another reform, The *Sound Dollar Act* eliminates a slush fund that has been abused by Secretaries of the Treasury in both Democrat and Republican administrations. To prevent future abuses my measure transforms the Exchange Stabilization Fund into a Special Drawing Rights Fund; liquidates all of the non-SDR assets over three years and uses the proceeds to reduce federal debt.

As you may know, in 1934 Congress placed the profits from the nationalization of privately owned gold and the subsequent devaluation of U.S. dollar in the Exchange Stabilization Fund and authorized its use to intervene in foreign exchange markets to support fixed exchange rates.[5] In 1968, Congress placed the special drawing rights issued by the International Monetary Fund into the Exchange Stabilization Fund.[6] After the Bretton Woods system of fixed exchange rates collapsed in 1971, the Treasury has used the non-SDR assets in the Exchange Stabilization Fund for purposes that Congress never intended, such as bailing out Mexico in 1995 and guaranteeing money market mutual funds in 2008. The *Sound Dollar Act* ends this.

Finally, the *Dodd-Frank Act* funded the Consumer Financial Protection Bureau by diverting the Federal Reserve's profits, which would otherwise be paid to the Treasury, to the CFPB so that it can avoid congressional scrutiny. This is a dangerous precedent. Nothing other than the operating costs of the Federal Reserve should be paid out its profits. Thus, the *Sound Dollar Act* ends this diversion and requires that the CFPB seek annual appropriations from Congress—just as other federal agencies do. There is no justification not to.

It's appropriate we have this discussion and debate about the Fed's role in the future of our country. On this day in 1933, just 24 hours after he became president, Franklin D. Roosevelt ordered the banks closed, banned the export of gold to stop a growing panic as the Depression intensified and called Congress back into special session.

To ensure America has thoughtfully prepared for the challenges ahead, the *Sound Dollar Act* proposes the best path to help United States retain its economic preeminence by preserving the purchasing power of the U.S. dollar. It does so by giving the Federal Reserve a single mandate for price stability and strengthening the Federal Reserve's independence even as the *Act*

increases the Federal Reserve's accountability.  These reforms, I believe, are critical to ensuring that the 21st century is another American century.

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[1] *The Federal Reserve Reform Act of 1977*, Pub.L. 95-188, 91 Stat. 1387, enacted November 16, 1977 as modified by the Full Employment and Balanced Growth Act of 1978, Pub.L. 95-523, 92 Stat. 1887, enacted October 27, 1978/

[2] Pub.L. 79-304, ch. 33, Sec. 2, 60 Stat. 23, enacted February 20, 1946.

[3] Ortiz, Guillermo and Yam, Joseph (Chairs of the Central Bank Governance Group), Issues in the Governance of Central Banks, Bank of International Settlements (May 2009).

[4] Ciorciari, John D. and Taylor, John B. (Eds.), The Road Ahead for the Fed, Hoover Institution (November 2009).

[5] *Gold Reserve Act of 1935*, Pub.L. 73-87, 48 Stat. 337, enacted January 30, 1934.

[6] *Special Drawing Rights Act of 1968,* Pub.L. 90-349, 82 Stat. 188, enacted June 19, 1968.