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Task Force on Monetary Policy, Treasury Market Resilience, and Economic Prosperity: Examining Monetary Policy and Economic Opportunity

Testimony of Joseph Wang

Good morning. Thank you for inviting me and I appreciate the opportunity to testify today.

My name is Joseph Wang and I am the principal of Monetary Macro, an investment research and advisory firm. I have over 15 years of experience across the fields of law, financial services, and monetary policy. My experience includes five years on the Open Markets Desk of the Federal Reserve Bank of New York, where I implemented monetary policy and studied the financial system. I hold a bachelor's degree in economics from Northwestern University, a J.D. from Columbia Law School, and an MSc. in financial economics from Oxford University.

I believe the Federal Reserve is unique among agencies in the wide discretion granted to it, and in the economic influence of its tools. The Federal Reserve's dual mandate and range of tools allow tremendous flexibility in undertaking actions that have a large impact the economy as a whole, sometimes in very uneven ways. The ultimate effect of monetary policy depends on many variables outside of the Fed's control, so it is a difficult job whose success rests upon good judgement. The significant discretion accorded to the Fed makes oversight especially important, but the complexity of the subject makes its actions difficult to evaluate. An understanding of the tools within the Fed's grasp and corresponding tradeoffs in their use can be helpful in that regard.

But before discussing their tools, I will note the Fed's significant influence over the economy stems in part from the ambiguity within their dual mandate of price stability and full employment. While price stability is a mandate given by Congress, the current 2% inflation target was decided by the Fed itself. The level of unemployment considered to be "full employment" is also decided by the Fed itself. Where they decide to set these goal posts have wide ranging impacts on every day people. For example, if the neutral unemployment rate were perceived to be higher, then significant job losses would be permitted.

Generally speaking, the two mandates call for conflicting policy prescriptions where above target inflation calls for tighter monetary policy that could also have the impact of raising the unemployment rate. And an unemployment rate perceived to be too high would call for looser monetary policy, which could also have the impact of raising inflation. The balance between the two mandates is a judgement left to the Fed, as is the appropriate timeline to meet their goals.

The Fed's discretion to set its own goals, to balance these goals, and to set timelines to achievement them makes oversight difficult. However, the Fed does provide a framework that sketches out their thinking.

The Federal Reserve's current framework is built on the post-financial crisis era, where the fear was low inflation. The framework calls for an asymmetric response to inflation that tolerates inflation overshoots, but responds to undershoots with a commitment to allow inflation to run above target in the future. This framework was reasonable when designed, but also may have contributed to the bout of higher inflation in recent years. Reports suggest it will be recalibrated at the next policy framework review.

Moving on to the Federal Reserve's tools – the Fed's primary monetary policy tools are interest rates and balance sheet policy. Regulatory policy is an additional tool that does not explicitly target monetary policy goals, but also has significant impact on the economy and financial markets.

The Federal Reserve has strong control over overnight interest rates, which in turn allows it to influence longer dated interest rates that are more economically impactful. Longer dated interest rates are largely the market's expectation of the future path of overnight rates, but are also influenced by supply and

demand dynamics. At times the Federal Reserve has directly purchased longer dated Treasuries in an effort put downward pressure on longer dated interest rates.

The reliance on interest rate policy means that the economic impacts of policy are primarily through interest rate sensitive sectors. Typically, higher interest rates would dampen economic activity in sectors like housing and autos as buyers in those sectors tend to finance their purchases. This lays the brunt of economic adjustments onto blue collar workers and aspiring home owners. Similarly, these groups disproportionately benefit from low-interest rate policies. Note that the overall economy's interest rate sensitivity varies over time, where an asset light services focuses economy tends to be less interest rate sensitive.

Interest rates also impact economic activity through a wealth effect, where higher rates lower the prices of financial assets and thus the spending power of households. Consumer spending can be financed from wages, debt, or by spending down wealth. A correction in the stock market and other risky assets from higher rates reduces the ability of asset holders to spend, and a stock market boom from lower rates does the opposite. Asset holdings are concentrated in a small percentage of the population, but that group has an outsized impact on economic activity.

One last note on interest rate policy is its impact on fiscal policy. As the level of public debt has risen, so has the level of interest rate payments. Interest rate expenditures now exceed $1 trillion dollars this year, in part due to the level of interest rates. An increasingly important side effect of Fed actions is its impact on the nation's budget.

The Fed's secondary tool is its balance sheet, which can influence interest rates and also allocate credit. The Fed can create money out of thin air and lend directly to borrowers or indirectly through purchases of debt. This is essential to performing its lender of last resort function, which has expanded in recent decades. The Fed was originally a lender of last resort to commercial banks, but in times of crisis has also expanded this role to include emergency lending to securities dealers, money market funds, corporations, and foreign central banks. Some of these actions were done in cooperation with Treasury. These actions were essential to restoring financial stability and avoiding potentially significant economic declines.

Fed purchases of securities are limited to a very small subset of assets that include mortgage-backed securities, which is in effect allocating credit to homebuyers. These purchases were important when they were first rolled out during the great financial crisis, which originated in the housing market. Most recently it was also deployed in the pandemic, where hundreds of billions worth of mortgages were purchased even as home prices nationally surged over 20% in a year. This boosted the housing wealth of homeowners, the business of homebuilding, but also pushed the dream of homeownership further away for a generation of young buyers. The distributional consequences of those actions look to last many years.

Regulatory policy is less visible, but also an influential part of the Fed's tool kit. Regulatory policy places constraints and costs on the actions of banks, which in turn impact their lending decisions. More stringent regulation reduces the willingness of banks to take risk and results in a stronger banking system. However, a more constrained banking system also limits the supply of credit to the public. Small and medium sized businesses are more heavily reliant upon banks for financing, while large businesses tend to borrow by issuing debt in the capital markets.

More stringent regulation also impacts the functioning of Treasury markets and level of interest rates. Banks and bank affiliated securities dealers are the primary market makers in the Treasury market. They

buy securities from one client, hold the securities in inventory, and then sell them to another client. Regulations like the supplementary leverage ratio place costs based on the size of a bank's balance sheet that disincentives low risk and high-volume activities. These regulations contributed to the strength of the banking sector through the pandemic, but also the malfunctioning of the Treasury market at that time. The Fed reacted by temporarily suspend the SLR on Treasuries for one year.

Other regulations can also directly impact the level of interest rates through demand for Treasuries. Regulations such as the liquidity coverage ratio mandate banks to hold certain levels of high quality liquid assets, which include Treasury securities. An increased demand for Treasury securities places downward pressure on interest rates.

In summary, the Federal Reserve has large latitude in setting its own goals and exercising a range of tools towards achieving those goals. How those goals are set, and which tools are used, have large impacts on the lives of the American people. This makes the task of overseeing the activities of the Fed both very important, and difficult. I thank Chairman Lucas for his wisdom in establishing this taskforce to improve the performance of monetary policy towards greater economic prosperity.