Testimony submitted to the House of Representatives Committee on Financial Services, Subcommittee on Monetary Policy and Trade, hearing on "Unconventional Monetary Policy," Wednesday, December 7, 2016, 10am (embargoed until the hearing begins).

Submitted by Simon Johnson, MIT Sloan and the Peterson Institute for International Economics.[1]

A. Main Points

1) The Federal Reserve System has been tasked by Congress with maintaining full employment while keeping inflation low.[2] All well-functioning industrial democracies have a central bank with a similar mandate.
2) During normal times, central banks respond to shocks and attempt to smooth out the business cycle primarily by altering the short-term "policy" rate of interest. In the U.S. this is the federal funds rate, and monetary policy decisions are in the hands of the Federal Open Market Committee (FOMC), comprised of the Federal Reserve System's Board of Governors and the presidents of regional Federal Reserve Banks.[3] (For the remainder of this testimony, I will refer to these officials and their decision-making by the generally used collective name, "the Federal Reserve.")
3) In the face of a severe financial crisis, any sensible central bank will consider taking more dramatic measures – to prevent another Great Depression. This is standard practice across all countries. The range of policy options depends on the income level of the country, the credibility of the central bank, and the "fiscal space" available (i.e., public debt levels and the ability of the private market to buy newly issued government debt at low interest rates).

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[2] "The Congress established the statutory objectives for monetary policy--maximum employment, stable prices, and moderate long-term interest rates--in the Federal Reserve Act." https://www.federalreserve.gov/faqs/money_12848.htm

[3] See the explanation of "Open Market Operations" on the Fed's webpage; https://www.federalreserve.gov/monetarypolicy/openmarket.htm

4) Prior to 2008, the defining historical experience regarding major crises, deflation, and depression was the large financial shock caused by the stock market crash of 1929, which caused lasting damage to the real economy in the U.S. (and in other countries) because of the way in which banks were allowed to fail – and because the Federal Reserve allowed the nation's money supply and credit availability to decline sharply.
5) As a result of that experience, the United States introduced deposit insurance to discourage bank runs and to protect retail depositors. The Federal Reserve – as well as leading independent analysts, such as Milton Freidman and Anna Schwartz – also thought long and hard about how exactly to respond to deep crises, and how to prevent the collapse of money and credit.[4]
6) When the world's financial system encountered serious problems in 2007-08, initially the Fed responded by lowering interest rates. In August 2007, the FOMC's target for the federal fund rate was 5-1/4 percent. By the end of 2008, this target had been lowered to nearly zero.[5]
7) With the economy in decline and the financial system on the verge of further serious problems, the Federal Reserve understandably launched a program of large-scale asset purchases of longer dated government and government-backed securities, an operation which became known as "quantitative easing". As part of this approach the Fed also expanded its "forward guidance" – attempting to signal that short-term interest rates would remain lower and for longer, as a way to reduce longer term interest rates.
8) After the economy stabilized, unemployment remained high and the recovery was slow – so there was a great deal of macroeconomic "slack". While there was an initial fiscal policy response, in early 2008 under President George W. Bush and again in early 2009 under President Barack Obama, this proved to be small relative to the scale of the problem. Further attempts to provide meaningful fiscal stimulus – including as recommended by the Fed – proved futile due to opposition in Congress.
9) As a result, the Fed engaged in two further rounds of quantitative easing. The form of the operation varied, but the goal was the same – to lower long-term interest rates below what they otherwise would have been.[6]

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[4] Friedman and Schwartz's book, *A Monetary History of the United States, 1867-1960*, Princeton University Press, 1963, influenced generations of economists and policy makers – and can reasonably be regarded as one of the most influential books ever within economics.

[5] See "Monetary Policy since the Onset of the Crisis," speech by Chairman Ben S. Bernanke at the Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, Wyoming, August 31, 2012, https://www.federalreserve.gov/newsevents/speech/bernanke20120831a.htm.

[6] Several good Fed explainers are available, e.g., https://research.stlouisfed.org/pageone-economics/uploads/newsletter/2011/201104.pdf.

10) Assessing the effectiveness of this kind of Fed operation is difficult, but the available evidence is that long-term rates were lowered, not just on Treasury debt but also on more risky securities.[7] Lower interest rates on credit help to support investment and the consumption of consumer durables, as well as house prices. The effects were not large and the recovery still proved slow, but quantitative easing at least helped push the economy in the right direction.

11) At the same time, while serious concerns were raised at the start of the quantitative easing program, the problem of unintended consequences was relatively minor. Inflation did not spiral out of control – in fact, inflation expectations have remained remarkably well anchored throughout this experience.

12) There is also no evidence that the Fed's policy caused a first-order distortion in asset markets, although Fed officials have always emphasized the need to "exit" this program carefully. So far, they have done exactly this – edging towards the normalization (increasing) of interest rates as the economy recovers.

13) In summary, quantitative easing was a legitimate and sensible response to extraordinary difficulties. This policy approach was well-grounded in history and long-standing analysis, including by Milton Friedman. Ben Bernanke, as a leading historian and analyst of the Great Depression, was well-placed to lead this program. The consequences were positive, although not large. Undesired side effects have remained relatively small.

14) Looking forward, however, there are two broader lessons.

    a. The U.S. should be more willing to use countercyclical fiscal policy in the face of crisis conditions. There continues to be an unfortunate lack of political consensus on this important point.
    b. We should focus on avoiding such crisis conditions, including by ensuring that our financial system is well-regulated and properly capitalized. We have made some progress on this front since 2008 but unfortunately not enough. And the latest indications from the incoming Trump administration suggests that the hard won lessons of the last crisis may soon be disregarded. This would put us on the path to another disruptive and damaging boom-bust-bailout cycle, which undermines medium-term growth, damaging the prosperity of most Americans, and undermining our role in the world.

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[7] Estimates vary, but the overall effect may have been around 100 basis points (one percentage point) on 10 year Treasuries, although there is a large error band around that number.

B. What Went Wrong?

Discussing the effectiveness of monetary policy – and the way it should be combined with fiscal policy – is important. But we should not lose track of the deeper underlying issues – and what forced the Fed to take dramatic action during and after 2008. The nature and structure of our financial system led to the deep crisis and still poses real risks to our collective economic future.

We should be attempting to strengthen the safeguards in the Dodd-Frank financial reform legislation. Repealing or rolling back that legislation poses a major fiscal risk – and it also raises the probability that the Fed would again have to enter unchartered territory with monetary policy.[8] The potential downside fiscal and monetary "tail risks" are not currently scored by the Congressional Budget Office, but this does not reduce the probability of disaster or reduce the impact of such a problem if it does occur.

In effect, a financial system with dangerously low capital levels – hence prone to major collapses – creates a nontransparent contingent liability for the federal budget in the United States.[9] This can only lead to further instability, deep recessions, and damage to our fiscal balance sheet, in a version of what senior officials at the Bank of England refer to as a "doom loop".

On December 5, 2016, the Volcker Alliance launched a very pragmatic report on the state of financial reform – arguing that we should continue to address risks caused by excessive reliance on short-term funding, the structure of money market funds, and the way risk has become concentrated in clearing houses.

In a discussion at the launch event, held at the National Press Club, Federal Deposit Insurance vice-chairman Tom Hoenig emphasized the need to ensure a proper (and higher) level of capital in the financial system, along with measures

[8] See Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*, Pantheon, 2010.

[9] See Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive," Stanford University, March 2011 (revised), https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf. For a comprehensive assessment of banking and why capital requirements should be significantly higher, see Anat Admati and Martin Hellwig, *The Banker's New Clothes: What's Wrong with Banking and What to Do about it*, Princeton University Press, 2013.

that limit the availability of safety net support both to large banks, as well as to the nonbank financial sector.[10]

Unfortunately, the pricing of risk suggests that participants in financial markets believe that some financial institutions are still Too Big To Fail.[11] The deeper underlying problem is that too many of our financial regulations and regulators remain captured, one way or another, by large banks.

Regulatory capture is not a new problem and George Stigler of Chicago University is still the best guide to the general issues. Unfortunately, since the 1970s, this form of cognitive capture has become a major macroeconomic risk – a big part of what went wrong in 2008 and a significant issue today, including for the next administration.[12]

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[10] All of Mr. Hoenig's speeches and writings on this point should be required reading. For one recent example, https://www.fdic.gov/news/news/speeches/spnov0916.html.

[11] On this point, see the recently released report by the Minneapolis Fed, "Ending Too Big To Fail," https://www.minneapolisfed.org/publications/special-studies/endingtbtf.

[12] In *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*, James Kwak and I analyze the history and issues in more detail.