

**James K. Galbraith**

## **Statement to the Subcommittee on Domestic Monetary Policy**

### **Committee on Financial Services**

### **U.S. House of Representatives**

(May 8, 2012)

Chairman Paul, Ranking Member Clay, Members of the Subcommittee, it is always an honor as a former member of the Banking Committee staff to appear before you. Today I feel particularly privileged as I was on the staff from 1975 through 1980 and on the team that drafted the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978. I drafted the Federal Reserve oversight sections of that act, and it was my responsibility to organize the hearings on the Conduct of Monetary Policy in those years, beginning with the enactment of H. Con. Res. 133 in 1975.

Let me join in the frustration that underlies the bills before you. The Constitution gives to Congress the right “to coin money, regulate the value thereof.” The Congress correctly delegates the exercise of that power, but it also maintains its authority to set goals and to supervise the execution of policy. It has been a long struggle to establish the right relationship between Congress and the Federal Reserve, and to bring the right degree of openness, responsiveness and accountability to that relationship.

I endorse H.R. 3428, which would remove the Presidents of the District Federal Reserve Banks from voting status on the Open Market Committee. The Presidents are not duly constituted “Officers of the United States” under the appointments clause of the Constitution. Their status as monetary policy-makers is anomalous, and as the Supreme Court ultimately declined to grant certiorari when the issue was litigated by Chairman Reuss and Senator Riegle many years ago, the only remedy is legislation. HR. 3428 would take a useful step along the path to a better central bank.<sup>i</sup>

That said, we cannot escape the need for a central bank. The United States before the Federal Reserve Act suffered from chronic deflation and financial panics; for this reason the period from 1873 to 1896 was known as the Great Depression, until the 1930s got that title. In the past century only the communist countries dispensed with central banks and private banking firms, and this arrangement did not serve them well.<sup>ii</sup> For this reason, I cannot join in supporting bills that would repeal the Federal Reserve Act or bar lending by commercial banks.<sup>iii</sup>

The key issue on which I would like to comment today is not whether to have a central bank or who should vote on policy. It is what mandate Congress should give to the central bank. This is an issue fraught with politics and ideology – and worse, with economic theory.

When I served on this staff, my colleagues included the Chicago monetarists Robert Weintraub and Robert Auerbach. We worked together under Chairman Reuss to develop the “dual mandate,” which was expressed as “to promote full employment, production, and real income, balanced growth, adequate productivity growth, proper attention to national priorities, and reasonable price stability” in the preamble of the Humphrey-Hawkins Act and as “maximum employment, stable prices and moderate long-term interest rates” in the Federal Reserve Act.

My staff colleagues were committed monetarists. They believed that the Federal Reserve should pursue a policy of monetary control, to contain inflation. But they did not try to dictate that to the Federal Reserve. Nor would I have tried to dictate the pursuit of full employment over all other policy goals. Writing economic theory into law is dangerous and we steered clear of it as best we could.

The purpose of the Full Employment and Balanced Growth Act in this area was instead to open a sustained dialog between the Federal Reserve and Congress, with honest and forthright reporting on economic conditions, on the outlook and on the goals and instruments of policy at any given time. We understood that conditions change. We realized that economic ideas flow in and out of fashion. We felt that the goals of Congress were best served by stressing the element of dialog and oversight, within a broad framework of agreed objectives.

The Humphrey-Hawkins Act did require the Federal Reserve to specify the range of growth rates of the major monetary aggregates that it believed consistent with its economic goals and objectives. This provision was not intended to impose a strategy of monetary control on the Federal Reserve. The intent was to permit the Banking Committees to monitor the Federal Reserve's forecasting and modeling. We felt that to allow the Federal Reserve to report in terms of economic forecasts alone would make it too easy to evade discussion of what might and should be done under differing conditions.

To stipulate an intermediate target range in terms of interest rates would, at that time, have been highly controversial. Money-growth target ranges were something conservatives could accept, because of monetarism, and that the Federal Reserve could tolerate because they were not the operational tool of open market policy. Then in the mid-1980s the relationship between money growth and prices collapsed and so did the idea that target ranges for money growth were a useful indicator of Federal Reserve policy. However, because the law had been drafted to be intellectually flexible, the congressional oversight procedures survived this statistical and academic upheaval.

This system has been in place for 37 years since H. Con. Res 133; 34 years since Humphrey-Hawkins. It has been used effectively on some occasions, less so on others. But it has stood the test of time. It has withstood changes in the wording of the law governing the hearings and reporting process. It is a robust procedure because it serves the interests of Congress, of the central bank, and of the public.

Two bills before you would now strike the employment objective presently found in the Federal Reserve Act, leaving only "price stability" and (in the case of HR 245) "moderate long-term interest rates" as statutory goals. In this they would emulate the model of the European Central Bank, whose charter stipulates price stability as the predominant mandate for that institution. HR. 4180 would be less flexible than the charter of the ECB, which permits the pursuit of other goals so long as the primary objective of price stability is met.

The presence of "price stability" among monetary policy objectives is established law; the question is whether it should be (apart from "moderate long-term interest rates") the sole stated objective. The case that this is so rests on a technical hypothesis, known as the "natural rate of unemployment" or "non-accelerating inflation rate of unemployment" (NAIRU). This hypothesis was advanced by Milton Friedman and by Edmund S. Phelps in 1967, and it has been a staple of textbooks, but also of controversy, ever since.

In a nutshell, the Friedman-Phelps natural rate hypothesis held that the labor market would settle the rate of employment and output, that money is "neutral" in the long run, and that any effort to create jobs with expansionary monetary policy would lead to runaway inflation. (The theory has bells and whistles, including "adaptive" or "rational" expectations and a "vertical Phillips Curve," but that is the essence of it.) From this it follows that the best strategy for monetary policy is to pursue a steady rate of inflation; other matters will take care of themselves. And from there one can argue that the best steady rate of inflation is a zero rate. It is this that HR 4180 and HR 245 would now write into law.

A variant on this position is called “inflation targeting,” which has been supported by Chairman Bernanke, at least in academic work. The theoretical target under inflation targeting is a *stable* rate of inflation, not necessarily a *zero* rate. Advocates argue that inflation targeting is consistent with the dual mandate, because (in their view) that rate of employment at which inflation is stable is the maximum sustainable rate. If that is correct, then the employment part of the dual mandate causes no harm and there is no cause to remove it. In a sense, under this view, the presence of “maximum employment” in the mandate is what *permits* non-zero-inflation targeting to be an accepted policy.

“Price stability” is a stricter standard. To remove “maximum employment” from the mandate would seem to imply a directive from Congress to pursue *zero inflation at whatever cost to jobs*. In a world where wages normally vary with the changing age structure of the population (they tend to rise as workers get older) and where some important prices are set outside the country, this is a mandate to generate unemployment, so as to force internal devaluation, in response to practically any form of internal change or external stress.

We can see a policy of this type at work in Europe, where there is a two-percent inflation standard. It is producing a relentless debt-deflation, under which unemployment rises, social institutions such as education, health care and transport are destroyed, and yet public deficits and the ratios of debt to GDP continue to soar. The unemployment rate in Spain today is twenty-five percent. At a meeting in Berlin in April, a high official of the European Central Bank stated that the ECB had been “fully faithful” to its mandate. Members of Congress might not be happy, should the Federal Reserve say the same thing at a moment when twenty-five percent of Americans were out of work. Unlike the ECB, the Federal Reserve is a statutory agency for which, ultimately, Congress is responsible.

HR 4180 makes an explicit commitment to certain ideas, including the NAIRU<sup>iv</sup>, the “neutrality” of money in the long run<sup>v</sup> and the accelerationist hypothesis. It makes debatable empirical assertions about the efficacy of a price-stability mandate; I attach for the record a book review from *Foreign Affairs*, showing that not even Ben Bernanke and his distinguished co-authors could make this case with conviction<sup>vi</sup>. HR 4180 also admits that the concept of “price stability” is not easily measured; it sets out an array of statistical issues that would have to be resolved. This recalls the “definition of money” problem that bedeviled us when monetarism was in fashion<sup>vii</sup>, calling to mind Goodhart's Law, which holds that as soon as an economic statistic is used for policy purposes, the meaning of the statistic will change.

Welcome to Hamelin, in other words. Economists do not know as much as some assert. The recent record of the profession, which massively failed to anticipate the great financial crisis, especially does not inspire confidence. But let me now try to step outside the narrow parsing of terms in statutes and textbook economics, to say a few words about the real world.

Back in the 1970s, we economists did feel that the Federal Reserve held vast powers over inflation and employment. That was a legacy of the post-war American self-image, of our power, wealth and influence, combined with the influence of brilliant polemicists such as John Maynard Keynes and Milton Friedman on many people.

Many economists hold a more reserved view now. Given the financial crisis and our deplorably slow recovery from it, many recognize that having honest, well-regulated banks is important – and that the damage done by catastrophic deregulation and desupervision cannot be repaired easily. So jobs will not easily recover, simply because interest rates to banks are low. To us, the fact that quantitative easing has been a disappointment is no surprise.

Many economists also now recognize that when inflation disappeared in the early 1980s it was not simply because of the powerful personality of Paul Volcker or the fact that Congress started transmitting the Federal Reserve's views to the public via the Humphrey-Hawkins hearings. Disinflation was global. The high dollar, world debt crisis, collapse of commodity and especially oil prices, collapse of the Soviet Union and rise of manufacturing in China were part of the reason. Once these causes were set in motion, the Federal Reserve had little control over the course of events. Statements by Federal Reserve officials in recent decades on their anti-inflation vigilance look silly now. Here we had a reverse King Canute, standing on the beach at low tide, congratulating himself.

The global economy is a fact. The financial debacle is a fact. We cannot escape from either one. In years ahead we may well face continuing trouble with resource prices. We surely face a future of fewer jobs, especially so long as we do nothing about debts and banks.

These are matters over which monetary policy, as such, has little influence. They cannot be fixed by fiddling with interest rates. They could not be fixed by returning to money-growth targets. We are in a realm where the appropriate response of monetary policy is not clear; it will depend, in part, on what happens in the world and on the decisions that Congress takes on other matters, such as financial sector reform, bank supervision, energy policy and job creation.

This reality should make us a bit less inclined to play King Canute, even if today there is a risk the tides may rise again. It should make us more inclined to study, learn, discuss and review, between Congress and the Federal Reserve, both the prevailing situation and the many lines of policy that will bear on the outcome. Whether to pay the cost of achieving any particular policy goal – including price stability – should depend on what that cost actually is. And that will depend on circumstances, which, as a point of notorious fact, you cannot rely on economists to predict.

Today in economics our pressing need is for a fresh look at theory, and a thorough revision of doctrines that have dominated the subject for decades. In view of this, any law prescribing a single line of thought for the Federal Reserve would be a serious step in the wrong direction.

Were we writing today the preamble of the Humphrey-Hawkins Act, or Section 2a of the Federal Reserve Act, it's likely that we would choose different language. But the language that is there, with its multiple goals and objectives, is flexible and pragmatic; it permits discussion to continue in times of uncertainty, when learning is needed. It does not lock either side into a rigid formula that it will then become necessary to evade. It is serviceable. That is the enduring value of the process now in place.

I close therefore by reminding you of the words of the immortal American poet, Ogden Nash:

“If there is one principle to Americans unknown,  
It is: leave well enough alone.”

Thank you for your time and attention.

- i HR 1401 would shorten the terms of the Governors and rearrange the memberships of Presidents on the FOMC; it offers improvement over current arrangements but it does not address the constitutional issue. For this reason I would prefer the solution proposed in HR 3428. Another solution would be to vest the entire voting power on monetary policy in the Board of Governors, and constitute the Presidents as a non-voting Advisory Committee. This would solve the constitutional question while making the smallest adjustment to present arrangements, since all the Presidents (or their representatives) attend the FOMC meetings in any event. In comparison, I can see no compelling reason to create full-time positions at the Board of Governors for functionaries whose entire job would be to contemplate a short-term interest rate that may not deviate from zero for years and years. On the history of congressional lawsuits against voting

participation by the District Bank Presidents on the FOMC, see Robert D. Auerbach: <http://tinyurl.com/7bw93cs>, especially this paragraph: “...during the 1980s, four lawsuits were brought to require the presidents of the twelve Federal Reserve Banks to be Constitutional officers: Presidential nomination and Senate confirmation. The complainants believed that individuals who vote on the nation's money supply -- and also vote on loans to foreign governments and warehousing funds for the Treasury, both bypassing Congress -- should not be internally selected without displaying their views and credentials in a public Senate confirmation hearing. The complainants were House Banking Chairman Henry Reuss, (Democrat, Wisconsin), Senate Banking Chairman Donald W. Riegle Jr. (Democrat, Michigan), Senator John Melcher (Democrat, Iowa) and The Committee for Monetary Reform (President and Chairman Randall E. Presley of a coalition of 95 corporations and 779 individuals). Two former staffers on the Democratic staff of the House Banking Committee assisted: Grasty Crews argued these cases and I was an expert advisor. The lawsuits failed and the use of internally appointed people to make government policies is still a contentious issue as is exemplified in the 2010 Reform Act's provision for the Inspector General of the new Bureau of Consumer Financial Protection.”

- ii The case of Hong Kong is celebrated by opponents of monetary discretion, but Hong Kong was a colony before it was returned to China in 1997. I also pass over such countries as Panama and Ecuador which have adopted the US dollar, and the zone franc countries of West Africa, which rely on Paris. All major industrial countries in the world today have central banks and private banking systems; to depart from this norm would be, at least, a substantial experiment.
- iii I confess I do not yet fully understand the thrust of HR. 2990, which I received only this past Friday. The bill accurately calls attention to the dire conditions faced by many Americans and calls appropriately for action. But the apparent direction of action, to forbid “lending against deposits,” seems to overlook the fact that bank loans create deposits in the first place. However, I have not had time to study the later sections of this bill in detail.
- iv See my article, “Time to Ditch the NAIRU” *Journal of Economic Perspectives*, Vol 11, Number 1, Winter 1997, 93-108. Available at: <http://tinyurl.com/7cf8jer>
- v HR 4180 thus denies the possibility of hysteresis, or path dependency, a concept that long-term outcomes are influenced by the course of short-term decisions. Hysteresis is fundamental to an evolutionary (which is to say scientific) view of economic process. It has been widely debated, and substantially accepted by many leading economists in recent years, undermining the concept of a long-run equilibrium for employment determined by non-monetary matters. However, these properly remain academic issues; Congress would be wise to avoid interjecting itself into debates of this kind.
- vi “The Inflation Obsession: Flying in the Face of the Facts” a review of Ben S. Bernanke, Thomas Laubach, Frederic S. Mishkin and Adam S. Posen, *Inflation Targeting: Lessons from the International Experience*, *Foreign Affairs*, January-February 1999, 152-156.
- vii The economist Kenneth Boulding summarized this in verse: “We must have a good definition of money/For if we have not/Then what have we got/But a Quantity Theory of no-one-knows-what?”