LEGISLATION TO REFORM THE FEDERAL RESERVE ON ITS 100–YEAR ANNIVERSARY

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LEGISLATION TO REFORM THE FEDERAL RESERVE ON ITS 100–YEAR ANNIVERSARY

Thursday, July 10, 2014

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, Capito, Garrett, Neugebauer, McHenry, Campbell, Bachmann, Pearce, Posey, Fitzpatrick, Luetkemeyer, Huizenga, Duffy, Stivers, Stutzman, Mulvaney, Hultgren, Ross, Pittenger, Wagner, Barr, Cotton, Rothfus, Messer; Waters, Maloney, Velazquez, Sherman, Green, Cleaver, Himes, Sewell, Foster, Kildee, Delaney, Beatty, Heck, and Horsford.

Chairman HENSARLING. The committee will come to order.

Without objection, the Chair is authorized to declare a recess of the committee at any time.

This is a legislative hearing to examine a bill put forth by the vice chairman of our Monetary Policy and Trade Subcommittee, Mr. Huizenga, to make certain reforms to the Federal Reserve System.

I now recognize myself for 5 minutes to give an opening statement.

When this committee first embarked on the Federal Reserve Centennial Oversight Project last year, we promised a thorough review of America's central bank. Today's hearing is this committee's 11th hearing on the Federal Reserve in the 113th Congress. Certainly, our understanding of the Fed has been enriched through discussion and debate among our colleagues and complemented by the knowledge and perspective of many distinguished witnesses and scholars, including those who are here today.

As the hearing schedule for the 113th Congress begins to wind down, I do wish to thank all of our colleagues and witnesses for their contribution to this project and the risk they undertook to provide such contribution. I say "risk" because I am reminded that Senator Nelson Aldrich, one of the legislators behind the Federal Reserve Act, noted that, "The study of monetary questions is one of the great causes of insanity." Hopefully, we can avoid that fate. Regardless, we do expect to issue a full report on our findings from the Centennial Oversight Project in the fall.

Today, we consider the first piece of legislation to arise from this process, legislation to begin to reinvigorate the Fed with the type of accountability to Congress and the people that the Founders expected of all Federal agencies when they drafted the Constitution. I, again, say the "first" piece of legislation because reforming an institution as old, entrenched, important, and as powerful as the Federal Reserve will be a work in progress. But it is work we must not ignore.

There are many excellent, capable public servants at the Fed who have served our Nation well and are currently serving our Nation well. But I believe a critical examination of the last 100 years of the Fed's actions reveals a mixed bag at best. And, most recently, we have seen a radical departure from the historic norms of monetary policy conduct, from an unprecedented use of Section 13(3) exigent powers to select intervention in distinct credit markets, to the facilitation of our unsustainable national debt, to a blurring of the lines between fiscal and monetary policy, all of which presents large and unwarranted risk to our economy.

Clearly, our work must be thoughtful, it must be careful, and it must be deliberate, but much is at stake, so we must not ignore it. Thus, I fully expect the legislative effort to continue in this Congress and the next.

A recurring theme throughout our hearings has been that monetary policy is at its best in maintaining stable, healthy economic growth when it follows a clear, predictable rule or path free from political micromanagement, as it did in the Great Moderation of 1987 to 2002.

Earlier in her career, Chair Yellen said at an FOMC meeting that following one type of rule, specifically the Taylor Rule, is "what sensible central banks do." I agree.

Let me make one thing clear at the outset. We do not suggest for a moment that Congress, much less the White House or Treasury, should conduct monetary policy operations. We continue to respect the Federal Reserve's independence in monetary policy.

But that independence and discretion must be paired with appropriate transparency and accountability. What we require today in this legislation is that the Fed use a clear map of its own choosing to set the course for monetary policy and share that map with the rest of us.

Additionally, the case for Federal Reserve independence when it sets monetary policy does not hold up when we consider the Fed's new powers under the Dodd-Frank Act to regulate an ever-increasing share of the American economy. The Fed should not be permitted to hide its prudential regulatory actions behind its monetary policy independence cloak.

So today, we consider a requirement, among others, that the Federal Reserve conduct cost-benefit analysis as it adopts new regulations. Even President Obama has issued two Executive Orders reaffirming the importance of thorough cost-benefit analysis by both Executive Branch and independent regulatory agencies.

Today's legislation includes a number of other additional transparency and accountability provisions which are badly needed for the Federal Reserve. It is clearly time to hold the Fed to the same openness and transparency that we demand of other Federal agencies.

In closing, two final points.

First, I want to thank Chairman Campbell and his subcommittee for all the great work they have done and will continue to do on the Federal Reserve Centennial Oversight Project. I want to thank Chairman Garrett, whose ideas have formed the bulk of the bill that will be before us today. And I want to thank Vice Chairman Huizenga for his work on this bill, as well.

Second, I want to emphasize again that I expect further pieces of legislation to follow. For example, we continue to examine the Fed's Section 13(3) powers as modified by Dodd-Frank. Also, many in the public have inquired about H.R. 24, the "Audit the Fed" bill. Counterintuitively, that bill falls under the jurisdiction of the House Oversight Committee, not our own. And we look forward to Chairman Issa bringing that bill to the Floor.

And I would note that today's bill contains a provision requiring the GAO to ensure that the Fed complies with our statute by auditing the monetary rule they submit to Congress and, thus, complements the "Audit the Fed" bill.

Again, our goal today is to begin the process of developing legislation that will ultimately strengthen the Federal Reserve in fulfilling its mission to maintain stable prices and job growth and ensure that the Fed's rulemaking process is transparent and predictable.

I appreciate our panel today for coming to the hearing.

I now yield 5 minutes to the ranking member.

Ms. WATERS. Thank you very much, Mr. Chairman.

Today, under the guise of reform, my colleagues on the other side of the aisle have put forth legislation that will cripple the Federal Reserve's ability to promote growth, stabilize the economy, and, in times of extraordinary crisis, take decisive action to avoid an economic collapse.

This legislation is a concession to the opponents of the Dodd-Frank Wall Street Reform Act by making the Fed's rulemaking more tedious, more expensive, and subject to endless legal challenges by those who do not agree with its decisions.

Unfortunately, this proposal follows a Republican roadmap we have seen too often on this committee: First, find a regulator charged with withholding Wall Street accountable or routing out the risky behavior that led to the worst economic crisis in 80 years. Next, claim that regulator lacks transparency or accountability and, therefore, must be reformed. Finally, push legislation purported to address these issues through unnecessary obstacles like cost-benefit analyses, new rules, and GAO audits, all of which are carefully designed to gut the agency's ability to do its job.

We have seen this play out with legislation impacting the Consumer Financial Protection Bureau, the Securities and Exchange Commission, and the Commodity Futures Trading Commission—cops on the beat that protect average Americans and our economy from bad actors in the financial system.

Today, Republicans take aim at the Federal Reserve, which played an integral role in stabilizing the economy at a time of intense crisis and which has continued to play an essential role in growing our economy and promoting full employment.

When the crisis hit, the Federal Reserve challenged conventional thinking on the limits of monetary policy and appropriately took quick and decisive action that kept our Nation from slipping into a depression. But the legislation we consider today seeks to prevent the Federal Reserve from taking such innovative action in the future, creating rules that would prescribe monetary policy based on a rigid set of circumstances and factors, ignoring the best judgment of experts.

Mr. Chairman, the Fed's Federal Open Market Committee (FOMC) contains many of the Nation's most respected economists from across the Nation. Its Governors of the Board are subject to democratic accountability through the process of Senate confirmation, and the overwhelming majority were confirmed by the Senate with bipartisan support. But this legislation would discount the experience, judgment, and discretion of these experts, instead putting decisions related to inflation and employment on autopilot based on a set of abstract factors.

If the Federal Open Market Committee did deviate from the rule, the legislation requires the Government Accountability Office to conduct a costly and time-consuming audit, one that would undermine the independence of the Fed, shake public confidence in its decision-making, and create unnecessary uncertainty in monetary policy.

Such a process needlessly politicizes the Fed's decision-making process, compromises its role as a pillar of the global financial system, and, ironically, creates more market volatility, not less.

Recently, Donald Kohn, 40-year veteran of the Fed, formerly Vice Chairman and a George W. Bush appointee, expressed his concern with this approach, stating, "I don't think this is a good idea. I am highly skeptical that adhering to a preconceived rule will be appropriate to achieving the Fed's objectives under many circumstances."

In addition, this legislation brings back the time-honored Republican tactic of cost-benefit analysis, imposing heavy administrative hurdles and new litigation risk that will significantly impair the Fed's ability to do its job in a timely manner. Like efforts with other regulators, this provision allows Wall Street to tie up the Fed's rulemaking in endless litigation, draining resources and impeding its ability to guard against risk to our financial system.

Mr. Chairman, this legislation does nothing to promote economic growth, create jobs, or ensure a more stable financial system. In fact, it enshrines a regulatory policy that lets bad actors run amok while regulators waste time dithering with audits and frivolous lawsuits. And it does so at a time when, post-Dodd-Frank, we have asked and need the Fed to do more than ever before.

I thank you, and I look forward to the witnesses' testimony.

And I yield back the balance of my time.

Chairman HENSARLING. The Chair now recognizes the gentleman from Michigan, Mr. Huizenga, the vice chairman of our Monetary Policy and Trade Subcommittee, and coauthor of the legislation before us, for 1½ minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman.

And this is a special day, not just because we are talking about this piece of legislation, but because I get to share it with a family member.

And sorry, buddy, this is what dads live for, embarrassing their kids.

My oldest son, Garrett, is here with us today, and I am thrilled that we could have him here.

[applause].

Chairman HENSARLING. Without objection, add another 10 seconds to the gentleman's time.

Mr. HUIZENGA. Thank you, Mr. Chairman.

And, Garrett, don't worry about it. There are a lot of other people who are going to be hanging on, trying to follow all this, as well, because it is very complicated.

But I appreciate this hearing today because, over the past several years, the Federal Reserve has gained unprecedented power, influence, and control over the financial system while remaining shrouded in mystery to the American people. This standard operating procedure cannot continue. We must lift this veil of secrecy and ensure that the Fed is accountable to the people's representatives.

That is why, along with Capital Markets Subcommittee Chairman Scott Garrett and my own chairman, Chairman Campbell, I introduced H.R. 5018, the Federal Reserve Accountability and Transparency Act, pulling back the curtain of the Fed by increasing accountability and transparency by limiting Fed officials' blackout periods to discuss policy with Congress, opening the rulemaking process, and requiring the Fed to provide a cost-benefit analysis for every regulation that it issues.

Additionally, this legislation urges the Fed to adopt a rules-based approach to monetary policy, as Dr. Taylor had talked about for a number of times, instead of the continued improvisation strategy currently being employed. Should the Fed fail to adopt a rules-based approach, it would then trigger an audit of the Fed's books.

I think it is important to note that our bill is complementary to H.R. 24, the Federal Reserve Transparency Act, which is before the Oversight Committee. It was introduced by our colleague, Paul Broun, and I am a cosponsor of it.

But Mr. Chairman, again, I appreciate you calling attention to this important issue. And I am looking forward to hearing comments from the distinguished panel on my legislation to rein in the Federal Reserve.

With that, I yield back.

Chairman HENSARLING. The Chair now recognizes the gentlelady from New York, Ms. Maloney, the ranking member of our Capital Markets Subcommittee, for 2½ minutes.

Mrs. MALONEY. I thank the chairman and all the panelists.

Oversight of the Federal Reserve is important, but the Federal Reserve Accountability and Transparency Act goes far beyond oversight. It attempts to blatantly influence the Fed's monetary policy, undermining the independence that economists believe is vital to a central bank's success. This bill also goes far beyond the "Audit the Fed" bill that this House voted on last Congress. As one newspaper described it, it is "Audit the Fed" on steroids.

Under this bill, every time the Fed deviated from the Republicans' desired monetary policy formula, the Fed Chair would be hauled up in front of Congress to explain herself. And, even more troubling, the Fed would be subject to a GAO audit and report of the monetary policy decisions, with Congress setting the parameters of the audit.

As previous Fed Chairman Ben Bernanke said, allowing the GAO to audit the Fed's monetary policy decisions would create a chilling effect and "would prevent the Fed from operating on the apolitical, independent basis that experience shows has been so successful in lowering inflation and promoting a strong economy for our country."

I would like to place in the record his statement before this committee on the prior bill, on "Audit the Fed." This goes far beyond that. But he explains the chilling, terrible effect it would have on the independence and the ability of the Fed to make economic decisions that are separate from politics but are good for the overall economy of this country.

The Fed's independence is very important and crucial. Its credibility with the markets as an independent operator that is committed to achieving the goals of price stability regardless of political consequences would be compromised.

So, while it is true that this bill doesn't force by law the Fed to follow a particular formula for interest rates, it does attempt to bully the Fed into following the Republicans' preferred monetary policy. This inappropriately interferes with the Fed's independence on monetary policy matters, and I find it deeply, deeply troubling.

I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, the chairman of our Capital Markets Subcommittee, and coauthor of the legislation before us, for 1½ minutes.

Mr. GARRETT. Thank you.

And I begin by thanking the chairman for holding this hearing to consider the legislation to reform the Federal Reserve as it passes its 100-year anniversary.

I want to thank the witnesses for appearing before the committee, as well.

I would also like to recognize the gentleman from Michigan, the vice chairman of our Monetary Policy and Trade Subcommittee, for taking the lead and working on this legislation to reform the Federal Reserve. And I thank you very much for taking that effort.

As the Fed passes its centennial mark, Dodd-Frank will soon mark its own 4-year anniversary. It is timely that this committee is currently considering how the Fed and Dodd-Frank have transformed our financial regulatory environment. I would submit that an already-muscular Federal Reserve bolstered by a 3,000-page financial reform law has resulted in a central bank that is on steroids.

Since Dodd-Frank's passage, the Fed has adopted a new mission of ensuring financial stability and serving as a macro-prudential regulator over our Nation's entire financial system. And while some raise a question about the appropriateness of granting such vast authority to a single regulatory body, especially an authority charged with the conduct of monetary policy, everyone should agree that great power must be accompanied by robust oversight.

Unfortunately, there has not been a corresponding increase of much-needed transparency at the Fed. The Fed's regulatory activities have taken place behind a fraternity-like veil of secrecy, obstructing openness and preventing proper accountability.

For this reason, today we will consider legislation that would take a step forward to establishing an appropriate level of transparency considering the bank's monetary, prudential, and supervisory functions. In particular, the FRAT Act would require the Fed to increase its responsiveness to Congress, increase the transparency of its regulatory activities, and foster accountability in its international negotiations.

And I would just add, Mr. Chairman, that in light of the fact that Fed Chair Yellen testified before the committee back in February, it has taken 4 months for her to respond to us, as we have just now received her responses at this period in time—

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from Ohio, Ms. Beatty, for 2 minutes.

Mrs. BEATTY. Thank you, Mr. Chairman, and Ranking Member Waters.

And thank you to our witnesses.

In addition to the comments, Mr. Chairman, that my colleagues have made in their opening statements, I must add that I am a little disappointed this morning, as I sit here wondering why we aren't working to improve our Nation's economy, rather than trying to find ways to hamstring the primary regulator responsible for overseeing the operations of our Nation's financial markets.

While I always welcome witnesses, I am disappointed that we continue to hold hearings on issues which are not at all time-sensitive to this committee. For example, with only 23 legislative days before the expiration of the Export-Import Bank, it seems a little shortsighted to hold a legislative hearing on a bill to reform one of the most effective agencies in the Federal Government, when what we should be doing is holding legislative hearings on H.R. 4950, a bill to reauthorize the Export-Import Bank, which would protect and create American jobs, help lower Americans' trade deficit, and, importantly for my conservative colleagues, reduce the Federal deficit.

I therefore encourage the chairman to strive to advance consensus-built legislation that can drive forward economic growth in a meaningful, policy-oriented way that helps, not harms, our Nation.

Thank you, and I yield back.

Chairman HENSARLING. The Chair now recognizes the gentlelady from Minnesota, Ms. Bachmann, for 1 minute.

Mrs. BACHMANN. Thank you, Mr. Chairman.

Tragically, the Federal Reserve's policies have facilitated deficit spending, encouraged the accumulation of $17.6 trillion in national debt, caused market volatility, failed to reinvigorate the sluggish American economy, and will cause inflation that will harm American families and businesses.

Fortunately, our colleagues, Mr. Huizenga and Mr. Garrett, have introduced bills to encourage the Fed to use a rules-based monetary policy, opening the Fed's decisions on international regulatory negotiations to public comment, bringing transparency to the Dodd-Frank stress test, clarifying the Federal Open Market Committee blackout period, and requiring cost-benefit analysis for all Fed regulations. I am pleased to cosponsor these bills.

The "Audit the Fed" bill will provide Congress with necessary tools to provide additional oversight to the Fed's ever-growing powers.

It is high time and long overdue for us to pass these bills and get this done. I congratulate my colleagues on getting this done.

And I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from Indiana, Mr. Stutzman, for 1 minute.

Mr. STUTZMAN. Thank you, Mr. Chairman.

And thank you also to our witnesses today.

Mr. Chairman, you and I and our House Republican colleagues have a long history of pushing tax and regulatory relief for families and small businesses. We do so in pursuit of long-term economic growth but also in the pursuit of fairness.

The question is whether monetary policy reflects our goals. The Fed's massive and growing impact on everyday Americans' lives and its $4-trillion balance sheet is at least as impactful as tax and regulatory policy.

Consider that the typical legislation in front of Congress is judged by a score from the CBO. The Fed, on the other hand, regularly weighs policies that can be judged by their impact on GDP.

It is critical that we preserve Americans' confidence in the objectivity of their central bank for the 21st Century and beyond. That is why the Fed must adopt a rules-based approach to monetary policy and focus on the long term.

I look forward to today's discussion and again thank the chairman for calling this hearing.

I yield back.

Chairman HENSARLING. We will now turn to our panel of witnesses, each of whom, I believe, has testified before this committee in the past, so I will provide very brief introductions.

First, we welcome Professor John Taylor, the Mary and Robert Raymond Professor of Economics at Stanford University and author of the "Taylor Rule."

Second, we welcome Dr. Mark Calabria, the director of financial regulation studies at the Cato Institute.

Third, we welcome Ms. Hester Peirce, a senior research fellow at the Mercatus Center at George Mason University.

And finally, we welcome Professor Simon Johnson, professor of economics at MIT.

Without objection, each of your written statements will be made a part of the record. Again, since I think you all have testified before, you will be familiar with our lighting system.

Dr. Taylor, you are now recognized for your testimony.

STATEMENT OF JOHN B. TAYLOR, MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

Mr. TAYLOR. Thank you very much, Mr. Chairman, Ranking Member Waters, and members of the committee, for inviting me to testify.

I would like to compliment Congressman Huizenga for bringing his son to this hearing. I always like to bring family members to my classes at Stanford. It really helps illustrate things. I was thinking of bringing my grandchildren today, but they are only 5 and 3. But, to tell you the truth, it is their future we are talking about here, so it is very important.

I want to focus my remarks on Section 2 of the Act, which is the requirements for policy rules for the FOMC.

Many people for many years have shown that when monetary policy is conducted in a rule-like way, economic performance is better. There is price stability, unemployment comes down, growth is stronger, and productivity growth is stronger.

That research is continuing. Just a few weeks ago, there was a conference at Stanford, where a whole slew of experts, some currently on the Federal Open Market Committee, spoke in favor of a rules-based policy because they know, they have seen that it works better.

And there is experience that shows that. As Chairman Hensarling mentioned, when policy has been rules-based, the economy has performed well. And the example of that is the 1980s and 1990s until recently. When it has not been rules-based, the economy has floundered and we have had higher unemployment. The 1970s are an example of that, and, quite frankly, roughly the last decade is another example.

So, the stakes are huge. I don't think this should be a partisan issue in any way.

Central-bank independence is very important, but it doesn't seem to have been enough to prevent these swings towards more interventionist discretionary policy compared to a rules-based policy. So that is why I think that some legislation that goes beyond central-bank independence is important, and that is why I welcome especially Section 2 of this Act.

Section 2 would simply require that the Federal Reserve stipulate its policy rule or its strategy for setting the instruments of policy. The Congress would not tell the Federal Reserve what policies to follow. That is the job of the Federal Reserve.

The Congress, of course, has responsibility of oversight. And so the idea of this legislation is, when the Fed deviated from its own rule, it would be required to explain why. It seems to me to be the essence of transparency and accountability. How could someone object to that?

I think the legislation is quite well-balanced, well-crafted, and well-designed. It definitely takes into account all the research I know about. And I have been doing this for 40 years, as you can tell by the color of my hair.

I think it reflects the fact there are differences of opinion of how monetary policy works. But, in that context, it puts limits on the degree of excessive intervention that takes place in, I think, a transparent and accountable way.

It certainly allows enough flexibility for the Federal Reserve to react during a panic like in 2008 the way they did. There is nothing in here that restricts the Federal Reserve's lender-of-last-resort responsibilities. Don't let people tell you that.

It also provides flexibility in the sense that the instruments of the Fed don't have to be fixed. They move around, but they do it in a predictable, understandable, rule-like fashion.

Moreover, the legislation is written in a way that if the Fed finds itself in a predicament because the world has changed or there is a special event, it can actually deviate from its own rule, as long as it explains why to the Congress and to the American people. It just seems so reasonable to require that.

The legislation builds on experience of previous attempts of requiring the Fed to report. Actions that were removed from the Federal Reserve Act in 2000, this essentially replaces them.

So I think it provides the appropriate degree of Congressional oversight without in any way restricting the independence of the Federal Reserve.

Of course, some will object. I have already heard some of the objections right here. But if you look at the transcripts of the Fed, if you look at the speeches of Federal Reserve Members, if you look at what they have written, there is almost universal support for the concept of a rules-based policy. It is hard to find exceptions to that.

Of course, they will say, well, maybe not now, we are not quite ready. But that is a difference of timing, really, not a difference of whether or not we should do it.

I believe the Fed could really improve this legislation if it had constructive comments to make. But even as it exists now, I believe this legislation could be made to work by the Fed, it would improve economic performance, and they would make it work.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Taylor can be found on page 89 of the appendix.]

Chairman HENSARLING. Dr. Calabria, you are now recognized for a summary of your testimony.

STATEMENT OF MARK A. CALABRIA, DIRECTOR, FINANCIAL REGULATION STUDIES, THE CATO INSTITUTE

Mr. CALABRIA. Thank you. Chairman Hensarling, Ranking Member Waters, and distinguished members of the committee, it is a pleasure to be back here. I hope I haven't started to wear out my welcome yet.

Let me first say that neither Cato nor I actually endorse specific pieces of legislation, but, with that in mind, I do think the general principles behind the Act are laudable.

I am going to try to touch on each section, but I am going to just quickly say about Section 2, Professor Taylor has literally written the book on the topic. There is not really a lot I could add. I will just say that I would associate my remarks and very much support pretty much 95 percent of what he said in Section 2.

So, with that, let me go to the other sections very quickly.

I think Section 3's changes on the blackout period are very reasonable. It certainly would help Congress do its oversight in terms of nonmonetary policy.

Let me say that Section 4 that covers the stress tests, I am worried because, since the stress tests are becoming such a core of bank prudential regulation, that they deserve scrutiny. I think they have repeatedly rested upon questionable assumptions. I would go so far as to say that I don't actually think they have been all that stressful, and so I do think they need more transparency. I am worried they are becoming a substitute for sound risk management and regulation rather than a complement.

More importantly, I am worried that the stress tests are encouraging greater uniformity across bank balance sheets. We saw this with the Basel Capital Accords, where they nudged banks into herding into similar assets, such as mortgage-backed securities and sovereign debt. Now, when everybody—that is, all banks—hold the same assets, then nobody is really a buyer. When everybody wants to be a seller, I worry that this contributes to fire sales and can cause, actually, shocks that would not be systemic to become systemic.

So I am very concerned about the direction of the stress tests. In my opinion, a robust financial system would be one with a greater diversity of asset holdings, business models, and funding sources. I would prefer that the Federal Reserve reduce its reliance on stress tests and instead focus on simple, verifiable measures of bank safety, such as actual unweighted levels of common equity that actually can absorb loss.

I will note as an aside, we were doing stress tests for Fannie Mae and Freddie Mac long before we were doing them for banks, and we saw how well that turned out.

Let me quickly say on Section 5, the shift from a minimum 2-year appearance by the Federal Reserve to a quarterly appearance I think would really help improve communications between this committee and the Federal Reserve.

Particularly, I think it would help a lot of junior Members. Obviously, the Chair and the ranking member have a tremendous amount of access, maybe not as much as they would like, but a tremendous amount of access to the Federal Reserve Chair. That does not hold true for Members across the committee. So I think having the Fed up here—and it is certainly worth saying that the Fed Chair is usually up here about 4 times a year anyhow.

The additional reporting requirements in Section 6, to me, are fairly reasonable and welcomed, certainly on the rulemaking side.

One of the things that has gotten the most controversy is Section 7's requirement for cost-benefit analysis. I feel that this would nudge the Fed to be more explicit about the assumptions that go into rules, which would encourage clearer thinking about the impact of those rules.

Of course, some would object that subjecting the Fed to the cost-benefit analysis would stifle the regulatory process. I will note that if you go back and look at the legislative history in the 1940s of the Administrative Procedure Act, the same things were said about notice and comment, that if you had to put rules out for notice and comment and public input, it would slow the process. Obviously, it does slow the process. It takes a minimum of almost a year to really do a rulemaking seriously. But I think our objective should be not speed but quality. And just as notice-and-comment has improved the regulatory process, I believe cost-benefit analysis would improve the regulatory process. I certainly, however, don't see it as a panacea.

One of the things that I want to emphasize that I actually think hasn't gotten much discussion but I actually think is one of the more important parts of the bill is that Section 8 of the bill allows individual Fed Board Members to have their own staff. This is the case at the SEC; this is the case at the CFTC. The Fed Board Members are far too dependent on the Chair, and they are far too dependent on the Fed staff. I would ask the Members of Congress here today to imagine what their lives would be like if they had no staff and they were dependent on the staff of the chairman of the committee. As much as I am fond of this chairman's staff, you know that you would be at a disadvantage. The Members of the Fed Board are the same thing. So, again, this is a very small thing, but I think it actually would have a very big impact in the long run.

Let me also emphasize, while several provisions of the bill address transparency in Federal Reserve rulemaking in the area of financial regulation, I believe our ultimate objective should be to get the Fed out of financial regulation. To me, that would increase the independence of monetary policy, but, just as importantly, and I think it is beyond dispute, the Fed has a lousy record at financial regulation. Despite its own problems, I would rather transfer those responsibilities to the FDIC. They have had their own problems, certainly, but I think they would do a far better job at it.

I will also note that I have a few suggestions for qualifications of Fed Board Members in my written testimony which I believe would increase the Federal Reserve's independence and reduce the degree of groupthink that so dominates the Board most of the time.

I also want to end with saying, a lot of the conversations are about independence from Congress. I think the far more pressing concern in my mind is that we have to increase the degree—and this is not a partisan thing. I want the Fed to be independent of every Executive Branch President. We all know the history of Arthur Burns and the Nixon Administration; they were far too close, by any measure. I think this Fed and I think the previous Feds have acted as adjuncts of the Executive Branch, and I find that far more problematic than any insights and any influences that this body might have.

Thank you.

[The prepared statement of Dr. Calabria can be found on page 61 of the appendix.]

Chairman HENSARLING. Ms. Peirce, you are now recognized for a summary of your testimony.

STATEMENT OF HESTER PEIRCE, SENIOR RESEARCH FELLOW, THE MERCATUS CENTER, GEORGE MASON UNIVERSITY

Ms. PEIRCE. Chairman Hensarling, Ranking Member Waters, and members of the committee, thank you for the opportunity to be here today.

I will focus my remarks on regulatory as opposed to monetary policy. Regulatory and supervisory practice are areas where the Fed does need greater transparency, accountability, and more rigor in their processes.

Before we look at these issues, we should think about some basic questions. Do we think that the Fed should be supplanting the private market in allocating capital and in designing the financial system? And do we think that it should be doing those things behind closed doors?

Dodd-Frank expanded the Fed's regulatory mandate over banks and non-banks, and the Fed has been aggressively pursuing that mandate. And as a consequence of that, the Fed has been changing the way it approaches regulation and using a macro-prudential approach, which allows it to intervene in private decision-making and direct private financial institutions in a way that it thinks will enhance financial stability.

But, as Dr. Calabria alluded to, that sort of push from the government towards the private sector has not always worked very well in the past. And to make matters more complicated and more troubling, the Fed has a penchant for nontransparency. What that means is that it is making these major decisions without the input from outside the Fed that might say, you are making a mistake, or you are taking an action that might actually be destabilizing the financial system.

We can take steps to improve the situation. One would be to enhance the Fed's accountability to Congress. And that could be done by having the Fed Chair appear more frequently before Congress. Another approach is to make sure that their regulatory agenda is being made clear and transparent to Congress so that Congress knows what regulations are in the pipeline.

Another step that we can take is that the Fed's rulemaking can be more rigorous, transparent, and accountable and afford more opportunities for public input. One way to do this is to have economic analysis. The Fed is an independent regulatory agency, and so, unlike Executive Branch agencies, it is not subject to Executive Orders that require economic analysis.

And so, in asking the Fed to do economic analysis, what you are really asking them to do is identify the problem they are trying to solve, identify some solutions to those problems, and then do a cost-benefit analysis to figure out what are the costs and benefits of each solution. And then, once you are ready to adopt a rule, you establish metrics so that you can go back several years later and see if your rule is actually working the way you intended it to work.

It is important for this process to be done transparently and in the public eye so that the public can weigh in and sharpen the Fed's analysis. Public input is also important in international discussions that the Fed is having. Of course, the Fed needs to be in constant communication with its international counterparts, but there is a concern that, internationally, decisions are being made and then they are being imported here without an opportunity for people here to weigh in.

And, aside from external accountability, the Fed should have some more vigorous internal dialogue, which Dr. Calabria alluded to. I think that is very important. And one way to do that is to enable each Governor to have a small staff of his or her own who can work on issues that are important to him or her and not be responsible to the Chair.

The Fed is turning 100, and it is an important time for us to think about reforms. I think we need to frame those by asking some fundamental questions. Do we feel comfortable with having the Fed supplant and override market decision-making? And if we do feel comfortable with that, what is the proper level of accountability and transparency and oversight?

Thank you very much.

[The prepared statement of Ms. Peirce can be found on page 84 of the appendix.]

Chairman HENSARLING. Dr. Johnson, you are now recognized for your testimony.

STATEMENT OF SIMON JOHNSON, RONALD KURTZ PROFESSOR OF ENTREPRENEURSHIP, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. JOHNSON. Thank you, Mr. Chairman. I would like to emphasize three points that I expand on in my written testimony.

First, I liked a couple of the statements that you made in a recent speech, I guess it was published in the Cato Journal. The first was that the Fed must maintain its independence with respect to monetary policy. And the second was the Fed must always be led by experts trained in the science of economics, including, you mentioned, the Austrian and Chicago schools of economics. I know quite a few of these people, and they certainly have plenty of that training.

I think those are laudable objectives and exactly the right goalposts to set. I think there is a tension, Mr. Chairman, between those goals and what you have in this legislation.

As Professor Taylor has said, and as he and many colleagues have established with a lot of research, there are some advantages to rules with regard to monetary policy, particularly the predictability that you hope the central bank will bring to the economy and bring to its communications. Central banks have moved a great deal in the direction that Mr. Taylor and others have urged over recent decades.

But what you have in this legislation is not going to make things predictable. This is worse than monetary policy by Congress; this is monetary policy by some sort of Spanish Inquisition. You are going to have the GAO come in and order these monetary policy decisions on a decision-by-decision basis on a fast timeframe subject to terms of reference drawn up by either the House or the Senate committee.

I am just guessing that control of the House and the Senate will pass back and forth between the two parties in coming decades, based on recent history. So someone else will control one of these committees, someone not aligned with the current Republican majority on this committee. What pressure are they going to be putting on the central bank? Is that what you want?

I think, as Ms. Waters said, you want an independent central bank with experts making the decisions. You need, certainly, to have accountability, absolutely. I think that is a very important goal. But the experts have to have the ability to make these decisions.

What you are going to get from this is a massive amount of volatility in financial markets. Imagine the research reports that people are going to be putting out. Remember when TARP was turned down the first time of asking in the House? Remember the volatility that came out of that? That is what you will be getting on a week-by-week basis under this legislation. Why would anyone who is pro-business, who is pro-private-sector-investment want that? I don't understand.

The second set of points are with regards to the cost-benefit analysis, the stress test, and the points about international negotiations. These are just designed to hamper effective regulation of any kind.

The Federal Reserve does already go for extensive public comments on any major rule. Take, for example, the Volcker Rule, about which I testified before this committee not too long ago. There was a very detailed, extensive period, there was a lot of oversight. And when there was a particular part of the Volcker Rule that was not satisfactory to both Republicans and Democrats—you had the hearing in January—they fixed it. That is how the system is supposed to work. That is how it works.

What you have with a cost-benefit analysis is a set of traps and snares that are designed to trip the regulators in front of the courts—procedural traps. The cost-benefit analysis doesn't even consider the major costs of excessive risk-taking in the financial system. It never has—the CFTC version, the SEC version, the versions put forward for the Fed. Massive financial crisis, loss of 1 year's GDP at least, damage across the American economy, from which we are still struggling to recover, doesn't figure in any of those tests.

The stress-test proposal would simply allow the banks to game the system more effectively. The details, the specifications, the scenarios are given out by the Fed in advance. What they don't tell you is the details of their models. Why do the banks want to know the models? So they can game the models.

Go back and read the documents that came out in the "London Whale" case. Look at the very detailed micro way in which the JPMorgan executive was telling a trader how to game the reporting in order to pass the various Fed requirements. Look at that language. That is what they would be doing on a regular basis.

And the international negotiations, you are putting a requirement in here that would completely prevent any attempt by the Fed to deal with an international crisis. Mr. Taylor says we should be able to do that, and I think he is absolutely right. You can't agree on a swap line without all this notification period. You can't have any of the regular daily conversations that I used to participate in when I was chief economist at the International Monetary Fund, at least as witnessing those negotiations. The Fed wouldn't be able to do any of that.

I do think the points about a Vice Chair for Supervision in the legislation make sense. I do agree that Governors having their own staff is sensible.

But I would say, particularly to Mr. Garrett, on these points about accountability and transparency, which are very good points and which were also in the earlier version of your legislation, you should be focusing more on the Reserve Banks. That is where there is an anachronism in the system. The Reserve Banks, the Presidents of which are sitting on the FOMC, are separate from, and not accountable to, Congress. Their Presidents are not appointed by anyone who is—not appointed in a direct fashion that is accountable to Congress. It is quite an anomaly which is left over from the 1913 Act.

And, particularly, I would emphasize the New York Fed. The New York Fed is a terrible problem, Mr. Garrett, from your perspective. And the head of the New York Fed is the Vice Chair of the FOMC. He has a quasi-fiscal responsibility. He is not appointed by the President of the United States. He is not subject to confirmation by the U.S. Senate. He doesn't come and testify to you on a regular basis. That job, President of the New York Fed, should become a Presidential appointment, like the Board of Governors of the Federal Reserve System.

Thank you.

[The prepared statement of Dr. Johnson can be found on page 75 of the appendix.]

Chairman HENSARLING. I thank each of the panelists for their testimony.

The Chair now recognizes himself for 5 minutes for questions.

Dr. Taylor, what are the risks to our economy if we do not pass Section 2 of this bill?

Mr. TAYLOR. I think, in many respects, you can look at the last few years to see the risks. It would be a period where we could again have the kind of bad economic performance we had.

Remember, we had a serious financial crisis, we had a Great Recession, and we have had, unfortunately, a slow recovery. And that is during this period where people have assessed the policies have not been predictable and rule-like. And I would go back to 2003, 2004, and 2005, where the rates were held very low for too long. It is a period where people are saying, is that happening now?

So I think the most likely risk is we would continue with this subpar economic performance, which no one wants to have again. I can't believe we would like to go through that again, but we run that risk very greatly.

Chairman HENSARLING. Dr. Calabria, a portion of your written testimony that you did not deliver orally since you did not focus on Section 2 says, "Section 2 does not require a specific model. In no way does it limit the Fed's choice of model. It simply requires the Fed to publicly share the model. All of the Fed's actions in recent years would have still been possible had Section 2 been in place. There is nothing in Section 2 that is inconsistent with the Fed's dual mandate, nor is there anything in Section 2 that would require the Fed to raise or lower rates. There is no compromise of the Fed's operational independence."

Dr. Taylor, do you agree with Dr. Calabria's assessment?

Mr. TAYLOR. Yes, very much so. I think the idea here is to exercise oversight that is the responsibility of the Congress but to continue to allow this independent agency to conduct monetary policy.

The difference from current law is that the central bank would be required to describe its strategy for setting its interest rate, for example, in a manner that can be understood and be analyzed. And that is frequently called a policy rule, which is simply a way to describe how the interest rate changes under certain circumstances. It is used all the time. The Fed is always looking at policy rules right now, but they just don't articulate it or talk about it very much.

So I agree very much with this. This doesn't really change the independence of the Fed. It has the ability to set its policy.

Those at the Fed who may disagree with this but are sympathetic to policy rules say, well, we will just do this on our own. But I think the truth is, if you look at the history, they have gone back and forth, and that has not been enough. So I think the experience is that we have to do something more. We have to—you have to hold them accountable to follow the kind of policy that works.

Chairman HENSARLING. In my opening statement, I quoted Chair Yellen from an earlier point in her career, where I believe she said rules-based monetary policy—I think she was actually speaking specifically of your rule—is "what sensible central bankers do."

I questioned her about this in her last Humphrey-Hawkins testimony. I don't have her testimony right in front of me. I hope I can do it justice. I think the essence of her answer was that she does not disagree with herself, but I think she believes that the timing is wrong.

Do you have a comment on that? And when might the timing be right if it is wrong today?

Mr. TAYLOR. I have talked to Chair Yellen for many, many years, decades probably, about this issue, and she has always been supportive of this kind of approach.

What she says now is the time is not quite right; we are still not in a normal situation, we are still too close to that financial crisis. And I just disagree with that. I think it is time to get back to the kind of policy that worked well in the 1980s and 1990s until recently. And, in a way, that is, to me, promising, because if the disagreement is about when, not if, then we are making progress.

This legislation goes further, in thinking not just about the current Chair but about the future of the Federal Reserve and how it operates. So I think it is very important to put in place something that provides the continuity in this very sensible way with which she has had so much experience.

Chairman HENSARLING. Dr. Calabria, in your written testimony, again, that you did not deliver orally, with respect to Section 2, you also said, "Why is it important to reveal the Fed's current operating model? So that it can be examined and tested by those outside the Fed. Only under such examination can we learn how accurately that model captures the real world."

Would you please elaborate?

Mr. CALABRIA. Let's start out with the observation that all policy choices entail some rule. It is either implicit or explicit. You have a model of how you believe the world works when you decide that A is going to result in B. So, certainly, the Fed is operating by a rule today.

The question is whether or not that rule is effective. I am sure that if Chair Yellen was here, she would probably express some concern that the last few years have not exactly worked out how the Fed anticipated it would. And I certainly think that is evidenced by how far off their forecasts have regularly been.

So if we are going to try to figure out exactly why have they been off—and my suspicion is certainly, within the Federal Reserve Board, they are asking themselves this question every day, why have our forecasts wildly been off every time—it is because they have to rethink the model.

So we could either rely on a small number of people across town to evaluate that model or we can try to incorporate all of the rest of us to try to figure out why that model works or does not work.

My point would be that we really don't know ahead of time. Economists have spent a lot of time—I think, with all modesty, we should probably, all economists, admit we don't 100 percent, maybe not even 50 percent know how the economy works. And you are not going to figure that out unless you put models out there, unless you test them, unless you disprove them and move on to other models.

And, again, I would emphasize, the Fed is operating under a model. It is time they shared it with the rest of us. I think it is, again, fairly clear that model has not successfully predicted the responses of the economy and that we all try to figure out what actually would work.

Chairman HENSARLING. The Chair now recognizes the ranking member.

Ms. WATERS. Thank you very much, Mr. Chairman.

Dr. Johnson, you expressed a number of concerns with the impact of requiring the Fed's monetary policymakers to prescribe a detailed rule for setting monetary policy which would then be subject to audits by the Government Accountability Office.

First of all, I am absolutely intrigued by the fact that we have our witnesses here today talking about why the Feds should have independence and how it should not have interference by the Congress of the United States. On the other hand, the testimony here by Dr. Taylor and others is basically a prescription for interference by prescribing a rule.

But I would like you at this time, Dr. Johnson, to elaborate a bit on why the imposition of GAO audits on a monetary policy rule would have a chilling effect, creating obstacles to productive work and bringing more partisan pressure to bear, as you put it in your testimony, and at the same time our witnesses have said, oh, the Feds will have all the flexibility that they want and they need. So, there are some contradictions here.

Could you comment on these GAO audits?

Mr. JOHNSON. Certainly, Congresswoman.

What we have learned over 100 years and what has also been learned in other industrial democracies is that you can and should have specification of the objectives of monetary policy coming from the legislature, in our case, coming from governments in other different kinds of democracies. So you tell the central bank what objectives you want. In our case, we have a so-called dual mandate. And then the central bank decides how to achieve those objectives, using the expert analysis that Mr. Hensarling accurately described in his article.

What you are doing with this GAO structure is you are putting in a set of people, as I read the law, who have this sort of prosecutorial power. They are auditing; they are going through everyone's emails. They are reconstructing exactly the base on what has happened. They are understanding the models that were used or were not used. They are doing this on a very rapid basis, according to the timeline in this legislation.

The exact terms of reference of those audits actually will be specified on a case-by-case basis, according to the legislation, so you don't know exactly what is happening on this fishing expedition. What are they going after? What are they looking for? What is the issue?

And it would introduce a huge amount of uncertainty for the individuals. Do individual Federal staffers need to obtain the advice of legal counsel, for example, which is what happens when GAO goes in or Inspectors General look at actions at the SEC and other places.

All of this has to affect how these experts interact. Are they just arguing about the substance, or are they thinking, okay, how is this going to look to the GAO? What is the pressure that is coming to us from different people in Congress, from the House committee and presumably from the Senate committee?

I really don't see how that is going to help you get the best expert analysis and decision-making to obtain the objectives that you, Congress, have set for the central bank.

Ms. WATERS. Ms. Peirce, do you believe that the individuals on the Open Market Committee of the Fed, whether they rotate or not, have the expertise that is necessary to do the job? Or do you think that the confirmation that they have been given is sufficient for them to be able to have good judgment?

Ms. PEIRCE. I certainly wouldn't question the judgment of the members of the FOMC. I would say that I think we all benefit from getting input from other people. And so putting out a rule to say what you do and getting other people to give you feedback on that is generally helpful for any expert in making a decision.

Ms. WATERS. So what you are basically saying is that in addition to their expertise and their backgrounds, perhaps those of you in academia should have more input and more advice and more influence on the Feds?

Ms. PEIRCE. I certainly wouldn't weigh in on monetary policy since I am a lawyer, and I think I would get killed by my co-panelists if I said that I would. So I would stay out of that.

Ms. WATERS. I will let Mr. Johnson weigh in on this, too.

Mr. JOHNSON. I think it is good to discuss Members of the FOMC. There is a range of opinions, and that is how Congress has decided, I think correctly, that monetary policy should be resolved, through this process of deliberation on the Open Market Committee.

These people communicate all the time. They are always giving speeches, they are always interacting. If you talk about the regional Feds, they have various kinds of advisory committees with which they are engaged. The same thing is true at the Board.

Perhaps we might wish for more openness, certainly at the regional Fed level. That is a fair question. But they are absolutely engaged in communicating, and people are pressing them all the time with these opinions. That is a very healthy part of our democracy.

Ms. WATERS. Thank you.

I yield back the balance of my time.

Chairman HENSARLING. The Chair now recognizes the gentleman from California, Mr. Campbell, the chairman of our Monetary Policy and Trade Subcommittee.

Mr. CAMPBELL. Thank you, Mr. Chairman.

And thank all of you.

Rather than me really asking some questions here, Dr. Johnson, you have given your very spirited opposition. While ostensibly agreeing with Dr. Taylor on lots of things, you have a very emotional and spirited disagreement with the elements of this bill, particularly Section 2, I guess. There are some elements that you agree with.

So Dr. Taylor, can you respond to some of his objections, please?

Mr. TAYLOR. Yes. I think that, as I hear Simon Johnson talk, his focus is not so much on whether we should have a rules-based policy; it sounds like there is agreement there. But it is just on how the accountability is brought into play. Now, I think you—

Mr. CAMPBELL. Can I stop you a second, Dr. Taylor?

Dr. Johnson, would you agree with that?

Mr. JOHNSON. If the Federal Reserve, the Board of Governors and the FOMC, were to decide to have a rule or to move closer towards Mr. Taylor, I am not going to raise objections to that, and I don't think that will be particularly a politically contentious question. You are decentralizing the decision-making to the experts. That is the principle under which we are operating.

It is the imposition from the outside of the rule with this GAO—

Mr. CAMPBELL. But, Dr. Johnson, if I can, we are not telling them what the rule should be. How is that any different, then—the Federal Reserve is chartered by Congress. It is the elected body here and the President who have to set these things up, and we have to provide some accountability. That is the way the Constitution works.

So we are not telling them what the rule should be. We are just saying, do a rule, because history shows that is more effective and also provides more accountability in the market.

Mr. JOHNSON. Well, Mr.—

Mr. CAMPBELL. One of the things that frustrates me, I will just say, is that I see today, out in the real world, it seems like we used to, when rules were in play, sit around and ask, what is going to happen to the economy, what is happening in the markets, what are my customers saying, what are my suppliers saying, et cetera, et cetera. Now all anybody cares about is, what is the Fed going to do? It is like the Fed is running the whole show. And to me, that is a distortion of the way the economy and the private sector should work.

So we are not telling them what the rule should be. We are not even telling them they have to follow it. But we are saying, please give the market some stability here, please give people—so that there is some basis upon which you are operating other than tomorrow morning the Fed wakes up and decides: let's do more quantitative easing; let's suck it back; let's put more in; let's do this and that; and throws everybody for a loop.

Mr. JOHNSON. Mr. Campbell, if you know, given the rule, why are you specifying in this detail the reference policy rule that has these specific ingredients?

And then why are you putting all this pressure on them to have this directed policy rule that needs to be in alignment with or close to or you have to come and explain on a regular basis why it deviates and then you send the GAO in to check, why this deviation? It is like a police state for the central bank.

Mr. CAMPBELL. The GAO? Having the GAO audit a government agency is a police—come on. The police state is the government they are auditing. That is the police state.

Mr. JOHNSON. So is the Department of Justice. That's a government agency.

Mr. CAMPBELL. The police state is the IRS. The police state is the EPA. The police state is all that. That is the police state.

Auditing is not a police state. Now you are really ticking me off. But I am going to go to Dr. Taylor here, who is itching to respond to your comments.

Mr. TAYLOR. This idea of the reference rule—as you remember, the reference rule is the Taylor Rule. In fact, I kind of like the idea of "reference rule" rather than "Taylor Rule" because it allows me to sound more objective when I talk about it.

But it doesn't require them to be following the reference rule by any means. It simply says, hey, there is this reference rule out there that there have been thousands of papers written about. And it appears—if you go to any market discussion that is out there being discussed, anybody who talks about a policy rule compares it to this reference rule.

So what is so harmful in just saying, as a reference, the Fed ought to do that? It is not required to follow it. It is just required to have a discussion like everybody else is having a discussion. And so I think it is a good idea to have it in there, but it doesn't really say the Fed should follow it.

Actually, if I could just add, the current Chair of the Fed recently gave a speech comparing what she thinks the policy should be with the reference rule. And so it is just a continuation of that thing, which I think is a healthy way to do it, and they would have to do that as part of their analysis.

Mr. JOHNSON. If the central bank—I think it is the central bank. And if the Chair of the Fed can persuade the Congress to move in the direction of having this rule or making these comparisons, I am in favor.

I am in favor of delegation to the experts, as Chairman Hensarling said in his article. That is what has served us better over the past 100 years than some other arrangement that we have tried and other countries have tried.

Mr. CAMPBELL. All right. Thank you both for that.

And in my last 10 seconds, I will just reiterate what I said before. I am in support of this legislation, but it can be modified.

That is why we are having this hearing. Maybe it needs some tweaks. Maybe there are some other things.

But we really need—it will be best if we can get the economy out of operating only on Fed action and, instead, operating on the action of the real economy, and that is what I hope this can move us to do.

I yield back

Chairman HENSARLING. The Chair now recognizes the gentlelady from New York, Mrs. Maloney, the ranking member of our Capital Markets Subcommittee.

Mrs. MALONEY. Thank you.

Dr. Johnson, I would like to ask you about the restrictions that the bill places on U.S. regulators'—the Fed and otherwise—ability to negotiate with their international counterparts, having to inform Congress and so forth.

As someone who used to work at the IMF, can you give us some insights on whether these kinds of international negotiations are important, especially in a globally integrated market such as finance.

And would the restrictions in the bill put the United States at a competitive disadvantage in finance and being part of these negotiations?

Thank you.

Mr. JOHNSON. Thank you, Congresswoman. I think it is a very important issue.

It depends, of course, on what you mean by "negotiation." The legislation is somewhat vague on that. But if you mean entering into discussions of substance about policy and about what we are going to do, what you are going to do, and how there might be some quid pro quo, this happens all the time.

Particularly if you are talking about financial regulation, you are talking about large, complex banks and other kinds of financial institutions operating across borders.

For example, to the extent to which they comply with capital requirements in different places, to the extent that they are generating or not generating systemic risk in various places, to the extent that you are providing support or not providing support to various aspects of the system, these are things that central banks talk about all the time.

Now, this is a delegation to experts again. There should be accountability. When there was a financial crisis, they were up here a lot; I think they testified before Congress 37 to 39 times in 2009. Those are the numbers that I have seen.

But this would tie their hands. This says you have to give 90 days' notice to Congress and in various other ways and getting public comment before you have any kind of negotiation with other—anyone, including central banks. That is going to make it much harder to operate central banking in any reasonable fashion.

And your point about competitive disadvantages is a good one. I think, if other central banks are able to operate in a better, more functional way, for example, within Europe between the Bank of England and the European Central Bank, for example, and the Swiss National Bank, and were excluded from that—at the moment we are in that inner core of the most credible, well-run central banks in the world.

If we had to step back from that, if our central bank can't go there or has to be mute in all of those meetings, that is a serious disadvantage to the broader competitors, not just of our financial sector, but much more broadly of our economy.

Mrs. MALONEY. All right. Could you elaborate more? How do you see that would hurt our economy and our jobs and our country?

Mr. JOHNSON. I think the most important issue that comes up on a daily basis is with regard to capital, for example, and there is a lot of agreement across the political spectrum that we need high, strong capital requirements or whether they should be Tier 1 common equity so it is fully loss-absorbing and so on.

Now, these financial institutions that we have allowed to operate across borders are very complicated. They have different capital requirements in different places. They are, frankly, gaming the system on an hour-by-hour basis, if not more frequently than that.

And the central bankers and other regulators need to be in constant communication with regards to, is there sufficient underlying capital protecting the taxpayer against the risks that have been generated by these various financial institutions?

If you run your capital requirements in a sensible way and recognize all the cross-border dimensions, then you get a safer system, not, I am afraid to say, a completely safe system, but a safer system.

If you have to exist in isolation, if you can only look at that part of JPMorgan Chase or that part of the BNP Paribas in your jurisdiction—because you are not allowed to talk to anyone else because that would be considered a negotiation—that is going to be a much less effective regulatory system.

And everyone across the political spectrum agrees we should regulate capital. There has to be minimum levels of equity capital in this business.

Mrs. MALONEY. Okay. Do you think that the cost-benefit requirements that this bill would impose on the Fed and the FSOC would just slow the rulemaking process down by suing in court? And, in your opinion, would this lead to better regulatory outcomes from a systemic risk perspective?

Mr. JOHNSON. I think that the cost-benefit analysis, as formulated here, is designed to trip up the regulator to—the courts, as you know, only test on procedural grounds, whether you checked every single box. If you didn't respond to a single report that was put at the behest of a single lobbyist on the industry side, you have trouble with that.

There is no standing for the public in these cost-benefit analyses. If the public thinks that the regulation is too weak, you don't have standing to sue.

The people who have standing to sue are the industry who filed a thousand comment letters and another thousand technical reports and you didn't get to the 999th one of them. Then the whole thing is going to get thrown back to you.

Of course, regulation becomes less effective and you are going to have, over the medium term, more systemic risk, more danger, more risk of a massive financial crisis and another deep global recession.

Mrs. MALONEY. Thank you.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Michigan, Mr. Huizenga, vice chairman of our Monetary Policy Subcommittee, and coauthor of the legislation.

Mr. HUIZENGA. Thank you, Mr. Chairman.

Man, there is a lot to cover. So first of all, I am going to talk a little bit about oversight. And I, like Mr. Campbell, was finding myself getting more and more steamed.

I cannot figure out, Mr. Chairman, why so many of my colleagues are willing to hand over their constitutional standing, I would argue their constitutional duty to fulfill oversight responsibility. All right?

So I started Googling "oversight." A CRS report popped up. CRS says, "Congressional—oh, but this is Wikipedia; so, we are not going really deep here—we can go even further—oversight refers to oversight by the United States Congress on the Executive Branch, including the numerous Federal agencies—U.S. Federal agencies. Congressional oversight refers to the review, monitoring, and supervision of Federal agencies, programs, activities, and policy implementation. Congress exercises this power largely through its Congressional committee system."

I then went even deeper. My son Garrett, who we have referred to and talked about, just got done with AP Government. So, guess what, I went to the AP Government flash cards on oversight. They say roughly the same thing.

What I can't figure out is why colleagues here are willing day in and day out to hand that responsibility over to an Administration, regardless of whether there is a "D" or an "R" behind it. What happened to the people who are going to go and fight for their legislative standing, constitutional standing? I don't understand this.

Second, let's get specific about my bill and Mr. Garrett's bill. Section 2(c)—all right?—page 5, for those of you following in the program. All right? Page 5 through page 8 is where we talk about this stuff. All right? We clearly lay out that—submitting a directed policy, requirements for the directed policy rule, and then going into what that GAO report is.

It says, when a rule is materially changed—that means significant—right, Ms. Peirce, the attorney?—significantly changed, then and only then will they go in. And, oh, by the way, that is after the open rules market submits—next page, on page 8—GAO approval of the update.

The Federal Open Market Committee shall submit an explanation for that determination that it either, A, cannot or should not be achieved.

They submit an explanation for that determination and an updated version of the directed policy to the Comptroller of the Currency of the United States and the appropriate Congressional committees. Oh, yes. By the way, that is us doing our oversight.

I think we have to look at this, and it seems to me that it is clear. If the Fed complies with the law and submits a real rule, none of what Dr. Johnson is describing can happen.

Submit a rule and then explain it. That is all we are saying. We are not saying what the rule is. We are not saying what the final goal is. Explain yourself.

Now, having gotten that out of my system, Dr. Taylor, I am curious who and what other central banks around the world use a rules-based policy and what has been their experience.

Mr. TAYLOR. I would say many have, during particular periods, and when they have, things have worked quite well. I would put it this way: they sometimes deviate, some more than others.

But there are quite a lot of studies that, as best we can, determine when a central bank is coming close to a rule or their policies are described by a rule like this or others and—

Mr. HUIZENGA. And have they experienced a Spanish Inquisition within their own oversights, structures?

Mr. TAYLOR. There are different approaches. Some countries require that the central bank follow a particular inflation target. Others, the banks adopt that themselves. But, no, I don't know of this inquisition problem occurring at all.

Mr. HUIZENGA. Let the record note that he is smirking while he is saying that.

I am curious, Dr. Taylor, and Dr. Calabria, do other central banks do the regulatory function to the level that we are seeing under this change with the Federal Reserve because of Dodd-Frank?

Mr. CALABRIA. It is certainly mixed. Some central banks around the world have no bank regulatory function. Some do not. There—

Mr. HUIZENGA. How about the ones that are more successful than others? They are not—

Mr. CALABRIA. There is actually a recent study by Barry Eichengreen at UC Berkeley—certainly no free-market radical—who came to the conclusion that those central banks that do not do bank regulation have less inflation and more economic stability.

So I go back to an earlier point I made, which is that I think we need to rethink whether the Federal Reserve should be the primary bank regulator here.

I do want to make a point before we end, though.

A lot of the conversation has painted the GAO—let me say, as someone who has often disagreed with the GAO, but as someone who has requested GAO reports as a staffer, someone who in the Executive Branch has been on the receiving end of GAO audits, I know of few parts of the Federal Government that are less political than the GAO.

They are a very unbiased organization. They are not like Inspectors General. They do not have subpoena power. They don't go around carrying guns. As you know, lots of agencies ignore them all the time. But I think that they are a very apolitical organization, as apolitical as you get in the Federal Government.

Mr. HUIZENGA. All right. And, unfortunately, my time has expired. But thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from New York, Ms. Velazquez, for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Dr. Johnson, at the height of the financial crisis, small businesses were severely impacted by a lack of access to capital.

There wasn't a day when this committee held a hearing where we didn't hear Members from both sides of the aisle talking about the fact that small businesses in their districts were having trouble accessing capital.

So I would like to hear from you, how could this bill impact the supply of credit for small businesses during periods of economic instability?

Mr. JOHNSON. Congresswoman, I think it is an important question and, obviously, not a hypothetical one. We have recently had this experience.

The point of delegating to experts is so that they can, at various points, decide that you need to take some actions different from what would be standard.

And in the case of a financial crisis, I think all the experts I know would argue in favor of extraordinary measures to try and preserve exactly the kind of thing you are talking about, which is credit available to small business, small business which has probably not been a big part of causing the crisis and which is a big part of getting the economic recovery.

Ms. VELAZQUEZ. Correct.

Mr. JOHNSON. So this is where we come to the issue of the chilling effect. I am completely in favor of oversight by Congress, and that, of course, was the point of all the hearings that you had not just with small business, but also with the Federal Reserve. That is why they were here so often explaining what they were doing.

We have a lot of very effective oversight built into the American system. But when does that oversight shade over and become a chilling effect? When do the experts feel that they can't make the decision on the basis of that apolitical expert knowledge? When do they feel that there is some sort of political agenda hanging over them?

I agree that the GAO, in some instances, is apolitical. But here in this legislation they would get specific instructions on the terms of each audit from this committee or its Senate counterpart. That has to have a chilling effect.

Ms. VELAZQUEZ. Thank you.

Ms. Peirce, Section 7 imposes cost-benefit provisions similar to those that were being imposed on the Securities and Exchange Commission, and it will require conducting cost-benefit analysis.

This unfairly ignores the extensive analysis that economists and experts of the Federal Reserve already do. They have to comply with the Paperwork Reduction Act, the Congressional Review Act, and the Regulatory Flexibility Act.

So although cost analysis is a similarly common-sense requirement, in practice, this provision will be highly unworkable.

And I would like for you to explain to me, how should the Federal Reserve value the benefits of preventing a financial crisis or averting a market failure associated with the absence of a particular regulation?

How would the Federal Reserve prove in court that the estimated benefits are reasonable if the crisis the Federal Reserve seeks to prevent through its regulation has never occurred? Will you explain that?

Ms. PEIRCE. Yes. I think that you raised a really important question, which is tying a particular rule to a crisis. We often try to justify rules by pointing to a financial crisis and saying, “Well, surely we want to prevent another crisis.” And we can all agree on that.

But I think that the discipline of an economic analysis requires the Fed to look at a particular rule and say this is the role that it would play in preventing another financial crisis, and it can make predictions about what the costs would be of a crisis and what benefits you would get.

And so then having that very rigorous and clear, you make your assumptions clear so that other people can challenge your assumptions. And you make the data clear that you are using, and then people can provide you additional data to challenge that.

And then, if that does get challenged in court, then the court can look and they can—it is more of a procedural thing to see what the Fed actually did.

Ms. VELAZQUEZ. So, Ms. Peirce, you don’t feel—and, Dr. Johnson, if you would like to answer—that this type of regulatory requirement will prevent the Federal Reserve from acting accordingly when we are facing an economic crisis?

Ms. PEIRCE. Not at all. And it gives the Fed—it may take the Fed a little bit longer to adopt a rule, but these rules are in place for years and years.

And so what we will end up with is we will end up with higher quality rules that enable—that stand the test of time better because it will have gone through a rigorous process.

Ms. VELAZQUEZ. So you don’t feel that it will be an attempt to bring the Federal financial regulatory oversight to a halt?

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentlelady from West Virginia, Mrs. Capito, chairwoman of our Financial Institutions Subcommittee.

Mrs. CAPITO. Thank you, Mr. Chairman.

I want to thank the panel, too.

One of the issues that I have discussed with current and former Federal Reserve Chairs is the effect that this low-interest-rate environment has had on our savers, and particularly our seniors.

I represent West Virginia. We have an elderly population. And a lot of our folks are trying to live within the boundaries of what they had planned for and those fixed-income products like CDs and everything to support their income.

So my question is: Would a rule-based monetary policy produce a more balanced approach that doesn’t overly penalize a saver, particularly those in their senior years who have actually saved and planned for the future? Do you see this rules-based monetary policy having any effect on that?

And, Dr. Calabria, I see you shaking your head. So I will give you a shot first.

Mr. CALABRIA. First, let’s start out—because I think it has been implied that a rules-based policy would necessarily always result in higher rates. That is not necessarily the case. There are certainly times in the past when a rules-based policy would have suggested lower rates.

But I would be the first to say that certainly my read of the evidence—and I will defer to Dr. Taylor on this—seems to suggest that a rules-based policy would, on average, have suggested higher rates over the last decade and certainly over the last few years.

Mrs. CAPITO. Would it—Dr. Taylor, go ahead, and then I will ask a follow-up.

Mr. TAYLOR. First of all, it is very important to realize that a policy rule doesn't necessarily mean higher rates or lower rates. It means that the rates are adjusted in accordance with the state of the economy—

Mrs. CAPITO. Right.

Mr. TAYLOR. —the way this works.

Right now, I would say most policy rules that are out there would suggest rates would be not zero, but positive—at least slightly positive.

I never would say we go there instantly, but it would be—should have been something that we could have been prepared for. So, in that sense, the zero rates would not still be there.

Mrs. CAPITO. I would say—

Mr. TAYLOR. I believe, to some extent, that would be because the economy is doing better.

Mrs. CAPITO. Right.

Mr. TAYLOR. It is a different policy, a better economy, and, therefore, higher rates. But even without that, they would be higher. And the zero rates cause other problems besides the ones you are mentioning.

The money market doesn't operate very well at that point. To the extent that quantitative easing is part of that policy, it is a massive intervention into the capital markets. Price discovery is affected.

And so there are a lot of unintended consequences as well as the fact that it is affecting frequently older people, causing them to take extra risks, et cetera.

Mrs. CAPITO. One of the things I think that—correct me if I am wrong here—would provide for would be the predictability of where to go.

So if you are looking for buying short term, long term, or somebody is helping you with financial planning, you may be able to plan slightly better. That is one of the advantages I see.

Dr. Johnson?

Mr. JOHNSON. I think, though, the reason interest rates are so low and the reason that your constituents are having so much trouble, the elderly ones, is because we had this massive financial crisis.

And we should be addressing that through other measures, including much higher capital requirements that would be complementary.

Mrs. CAPITO. Which I think they are. Correct?

Mr. JOHNSON. So I just—and I like to quote John Allison, who is the head of the Cato Institute and a former BB&T executive, who was arguing recently for a 20 percent capital ratio.

I think that is something you can agree on across the political divide here that would exactly address your problem, Mrs. Capito, which is to make the world safer for people who rely on those fixed-income products to finance their requirement.

Mr. CALABRIA. Mrs. Capito, if I can make a point?

Mrs. CAPITO. Yes.

Mr. CALABRIA. Because I do agree with this, but I do want—this ties back to an earlier point because Professor Johnson has repeatedly told us that we need to rely on the expertise of experts.

I would remind him that a decade ago, the Federal Reserve was arguing for eliminating any sort of leverage ratio in the Basel Capital Standards.

And certainly, when I was a staffer on the committee—and I am going to applaud the efforts then of Senator Shelby and Senator Sarbanes to push back on the Fed—we would have not have heard that if it weren't for the FDIC telling on them, basically.

So, having this advance notice of what is going on internationally delayed the implementation of Basel II, which meant that American banks actually had—as little capital as they had, they had more capital than they would have had they implemented Basel II.

Mr. JOHNSON. There is no question—

Mrs. CAPITO. I am going to—I will let you guys debate when you—

Mr. CALABRIA. My point is that—

Mrs. CAPITO. I want to ask one more question on the cost-benefit analysis because this is something that I think is being held out as some sort of villain here when I really think—we have heard repeatedly in this committee in testimony from all kinds of employers and financial institutions, et cetera, on the—not so much one—the burden of one additional regulation, but the cumulative burden.

And I think if you are looking at a cost-benefit analysis of adding a new regulation rule, that is where the value could really be, not looking so much at one singular rule or regulation, but looking at how it is reacting and interacting with all the other ones that are already in place.

And, with that, I see I have lost the rest of my time. But thank you.

Chairman HENSARLING. The Chair now recognizes the gentleman from Missouri, Mr. Cleaver, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

And I thank the witnesses for being here.

I just have one question, but I want to preface it by expressing a personal opinion, which is that after 6 years during which our economy teetered on the very edge of collapse, our country is moving forward.

And I think most of the economic news that we are seeing and reading about is positive, and we seem to have climbed out of the depths of the Great Recession.

We are increasing our GDP, lowering the rate of unemployment, although the unemployment numbers seem to be a bit stingy. I think there are some socioeconomic reasons for that, but we can see that we are improving the state of an almost-devastated housing market.

Now housing sales, at least based on what I am hearing from my REALTORS®—the REALTORS® in my district, are the strongest they have been since 2006.

And so I am applauding the economic growth, and I believe that the Fed has taken many proactive and, yes, unconventional steps to resuscitate our economy.

And so, Dr. Johnson, I am wondering whether or not you think—and, frankly, all of the members of the panel—that, had the proposed reform been effective during the beginning of the 2008 financial crisis—do you think the Federal Reserve would have been able to do what they have done in the midst of being constrained from taking proactive measures to get us back on track?

Mr. JOHNSON. I think that is a very good question, Congressman, exactly on target.

Now, I understand that, hypothetically, you could read the legislation to say there wouldn't be a constraint, that they could just say, "It is a crisis. We are going to do these dramatic things."

But if you think back to 2007, 2008, as the crisis began to develop, how much controversy there was about what the Fed should be doing, how it should be doing it, the pressures that they faced, you could add this on top of all of that—and there was appropriate oversight. Right? So there were plenty of times that Mr. Bernanke and his colleagues appeared before this committee and other committees to explain what they were doing—but you would add another layer on top of here, which could potentially have been about multiple audits and creating this uncertainty, for example, for financial markets, is this or that Fed decision going to be second-guessed or is there going to be pressure to overturn it from a particular House or Senate committee.

I don't think having Congress involved in this kind of micromanagement, which is what it is, of the Federal Reserve is a good idea, in general. I am particularly worried about what would happen at times of national emergency, including financial crisis.

Mr. CLEAVER. Yes. I would like for you to respond. I just need to say before you, sir, my thought was, because I was here during that time—I think everybody on this committee is reasonably sharp. Some of us have degrees in geography and physical education.

I am just wondering how impactful and positive Congressional interference would have been.

Mr. TAYLOR. Congressman, I think it is very important to go back in time to before the crisis hit to answer your question.

There was a period, especially 2003, 2004, and 2005, where the interest rate was very low and then was raised very slowly. By most analyses—and there is disagreement—that was a period where the Fed deviated from the kind of rule that worked well in the 1980s and 1990s until that time.

I believe that was one of the reasons for the search for yield, the excesses in the housing market, not everything, but which ultimately led to the bust and, therefore, to this terrible situation we had in the crisis, in the recession, and the slow recovery now.

So, to me, if this kind of legislation had been in place then—and, remember, in the year 2000, the legislation is reformed to take out reporting requirements.

But if in 2000 say, for example, this kind of legislation was put in place instead, at least the Fed would have been up here explaining and being questioned about why it deviated from its policy.

And I think, ultimately, it would have deviated less and we would have been in a much better situation. The economy would have performed much better in the last decade than it has.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, chairman of our Capital Markets Subcommittee, and co-author of the legislation.

Mr. GARRETT. Thanks, Mr. Chairman.

So let's look to see where we all agree. And it sounds like, actually, there are a number of points on which the entire panel agrees on the underlying legislation.

Mr. Campbell from California raised a point. He said that businesses should not be so focused on what the Fed is doing every day. They should be focused on what the markets are doing, what consumer demand is, what is the volatility of the markets, what suppliers are, and that sort of thing, and not so much on the Fed.

And I think, if I looked at the panel, you would all agree with Mr. Campbell's assessment that we are too focused on the Fed's activity daily as opposed to—do I get a nod sort of like that? Sort of.

So then the question is: How do we turn that around? Now, one piece in the bill simply asks that the Fed Chair, instead of coming up to Congress twice a year, that he or she comes up here 4 times a year, quarterly.

Does anybody disagree about having the Fed Chair come up here quarterly as opposed to twice a year? Is that a bad thing as far as—just say yes. Does anybody disagree with that?

Mr. JOHNSON. Yes. I disagree with that.

Mr. GARRETT. Oh. Okay. See, here I thought we could get over saying that we agree.

Because my next question was going to be: Does anybody disagree with the next provision, Section 6, which says, on the supervisory and regulatory side, we have that the Fed Vice Chair of Supervision should also—it is their responsibility to come up semi-annually to testify as far as regulations?

Does anybody disagree that he or she should be coming up and testifying semi-annually on what they are doing? Does anybody disagree with that one?

Mr. JOHNSON. I do more than agree, Mr. Garrett. I think you have very good language in there about who should testify when there isn't a Vice Chairman of Supervision.

Mr. GARRETT. Yes. All right.

Mr. JOHNSON. In terms of implementing Dodd-Frank, that is essential.

Mr. GARRETT. So there is some disagreement as to how often the Fed Chair should be coming here. And the question there is: What good does it do actually when the Fed Chair does come here?

Because, as you know, the Fed Chair was here—when was it, Mr. Chairman?—about 4 months ago. And, at that time, we had some specific questions as to what she was doing, and we asked them and said, "Would you get back to us?" Four months later, we just get our answers now.

Would anybody say that a 4-month response from the Fed is a timely and responsive and responsible response from the Fed? Does anybody say that is timely, responsive, and responsible?

Mr. JOHNSON. Mr. Garrett, what exactly were the questions? Were they detailed, technical, hard questions—

Mr. GARRETT. Well, we got the answers back.

Mr. JOHNSON. —or were they straightforward questions? We don't know those details.

Mr. GARRETT. Then, I guess the American public doesn't know the answers either. And that goes to the overarching question of—to my first question, if we can't have certainty in the marketplace, then the market is continually going to be looking on a daily basis to what the Fed is doing.

All the underlying legislation is trying to do, is to provide certainty in the marketplace. We are not telling the Fed what to do. We are just saying, "Please, please let us know what you are doing and give it to us in a timely manner."

One way to do that is to help us out with an economic analysis. Now, this wasn't my idea. We crafted our language from President Clinton's and President Obama's Executive Orders.

Apparently, those two gentlemen thought it was prudent that the American public have, from their Federal agencies, an economic cost-benefit analysis before agencies take actions to see whether the cost of something is greater than the benefit.

So does anybody disagree with President Clinton and President Obama when they signed Executive Orders saying that there should be cost-benefit analysis for the agencies that they did? I guess there is always one.

Mr. JOHNSON. Can you take the Executive Order cost-benefit formulation to the courts in the same way that you could take your legislative cost-benefit analysis to the courts, Mr. Garrett?

Mr. GARRETT. Actually, we can, because the courts have been able to do that, and the district court was quite able to do that.

As a matter of fact, the district court overturned a decision of the SEC, saying that the SEC did not follow the proper cost-benefit procedure.

Mr. JOHNSON. In that case, I think President Obama and President Clinton got it wrong along the terms that you specified. I don't think the court should have that ability to trip you up on these technical details.

Mr. GARRETT. It is interesting that, once again, I have to be here and to be a defender of President Clinton and a defender of President Obama.

But if that is my role, then I am willing to do it in this one regard, because I think the American public does have a right to have a balance done on the benefits of the cost and the analysis.

Let's get to the issue of transparency in only 36 seconds.

Dr. Calabria, in your testimony, you write that the independence of the Fed has been greatly eroded by the revolving door between the Federal Reserve and economic policymakers in the Executive Branch.

All of our discussion so far has been about how much overt influence that we are going to have, as Members of Congress? Could you talk about how much overt influence the Executive Branch has?

Mr. CALABRIA. Let's start for—either—so look at the current Board. Three out of five members of the current Board worked at the Clinton White House, not the Clinton Administration, the Clinton White House. So if you want an apolitical Fed, this is not it.

As I suggest in my testimony—and I think this is applied across any Administration—no one should be eligible to be a Fed Board Member for at least 4 years after they have left an Executive Branch appointment. There is really just too much of a revolving door between Wall Street, Treasury, and the Fed.

Mr. GARRETT. Thank you.

I see my time has expired. Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Illinois, Mr. Foster, for 5 minutes.

Mr. FOSTER. Thank you.

Dr. Taylor, 3½ years ago you were a coauthor of an open letter to Chairman Bernanke, basically criticizing his decision to do the large-scale assert purchases and predicting, among other things, currency debasement and inflation.

We have been hearing that consistently over the last 3½ years from Members across the aisle—my colleagues across the aisle.

And I was wondering if each of you could, in one or two sentences, explain why those predictions have been so wrong for so long. And try to limit it to two sentences so we can—

Mr. TAYLOR. My criticism of the quantitative easing and related activities had two risks.

One, it was a downside risk, the uncertainty that it caused, the fact it could—unwinding would be uncertain, which was a negative, and the other is the other side, that it could be inflationary.

What I think we have seen is the first risk. The economy has not performed very well. It has been disappointing by every measure until very recently, and that is not good.

Mr. FOSTER. That is not—

Mr. TAYLOR. That is the reason why the inflation rate has been so tame. It is a very weak economy.

But we still—just to finish the answer, we still risk inflation if the Fed is unable to unwind. Lots of people out there are saying they are behind the curve already. It is still a risk.

And I say that letter, which I signed onto, raised a lot of issues about the dangers of these kinds of policies, and I think, to some—to a great deal, that those dangers have been realized.

Mr. FOSTER. But not inflation, you would agree.

Mr. TAYLOR. Well, look. You have an unusual policy which creates many kinds of risks. Probably the greatest concern is the slow economy and the fact that unemployment took so long to get down.

That is, to me, a tragedy. We not only had a deep recession, we have had an abysmally slow recovery. I don't think that is a good reflection on that policy.

Mr. FOSTER. It is a question of what the alternatives are. If you believe that doing something that would increase the output cap would actually have made the economy healthier, then that is a discussion that probably is also worth having.

Next, Dr. Calabria?

Mr. CALABRIA. First of all, I would say I am not only concerned about certainly headline inflation, I am concerned about asset prices. It is very unusual to have a financial crisis without some sort of run-up in asset prices.

We could have had—you and I would have had the same conversation 10 years ago, and we would missed the financial crisis, we would have missed the housing bubble. So, quite frankly, I do think we need to be worried about asset prices.

I also think we need to be worried about the Fed paying interest on reserves for years has been contractionary. Why are we paying banks to have trillions of dollars sitting on the sidelines doing nothing?

So I do think that sometimes the conversations sound like the Fed is either purely expansionary or purely contractionary. I think the Fed is a bit schizophrenic right now, quite frankly.

I think they are doing things that are contractionary. I think they are doing things that are expansionary. And the net effect has been a mixed one. So, certainly, I just don't think they have had a consistent set of policies and certainly I am—

Mr. FOSTER. I am trying to count sentences here.

Mr. CALABRIA. Okay. Well—

Mr. FOSTER. No. I understand.

Mr. CALABRIA. As you know, the two-hand economist bit with Truman. So that is the same here, one hand or the other.

Mr. FOSTER. Okay.

Ms. Peirce?

Ms. PEIRCE. Just with the caveat that I am not an economist, I am concerned about the Fed's policies, buying mortgage-backed securities, for example—they are having a big impact on the market—and then something that Mr. Campbell alluded to earlier, which is that watching the markets react to whatever the Fed says is pretty disturbing. I think it would be much better if the market were reacting to the market.

Mr. FOSTER. All right.

Dr. Johnson?

Mr. JOHNSON. Mr. Foster, good question.

I think this quantitative easing was risky. It certainly has not produced inflation. There were legitimate concerns about that, but it hasn't.

It also hasn't miraculously pulled us out of this hole created by the massive financial crisis. I think there is a limit to the magic that central banks can work in this kind of situation.

I do think, though, the question is a good one because, imagine, under the proposed legislation, you are going to be having hearings on a weekly or at least monthly basis all along exactly these lines with teams of experts like this all disagreeing. You all are going to be disagreeing. Some of you are expert. Some of you are perhaps less expert.

This is not particularly going to be helpful to the Federal Reserve trying to do its job. You should be asking questions about who gets appointed to the Federal Reserve, what are their qualifications.

I don't have a problem with Mr. Calabria's suggestion that you can't put people on the Fed who have been working in the Executive Branch. I think that would rule out McChesney, Martin, Burns, Volcker, and Greenspan, but, of the current Board, only Lael Brainard, I think. So those are legitimate questions.

Mr. FOSTER. In my 25 seconds left, if I could just have a quick "yes" or "no?"

Do you think that the Federal Reserve should have a larger role and a larger part of its thought process in trying to limit asset price bubbles, in particular, real estate?

You can see other countries have done this with some success. And do you think that should be an increased part of their portfolio or not, which is—I know.

Mr. TAYLOR. I think that the first thing the Fed can do about asset bubbles is to have a policy of interest rates, a monetary policy that doesn't bring them on. I really mean that.

Mr. FOSTER. Okay.

Mr. TAYLOR. A lot of the actions that have been taken recently by countries on—that have focused, say, on bubbles and housing have been because their interest rates are low.

Take Switzerland. If they have a low interest rate, they attack the housing market with other mechanisms. Take Singapore. They have the zero rate because the Fed has a zero rate. They have to take special actions to contain the bubble in their housing and automobile markets.

So, they are kind of responding to the fact that monetary policy is stuck and not doing its usual thing. And I think the first thing to do is to make sure the central banks, our central bank in particular, don't cause the bubbles and then worry about what to do with it.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Texas, Mr. Neugebauer, chairman of our Housing and Insurance Subcommittee.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Thank you for holding this hearing.

And I thank our panelists for being here.

I really want to talk about Section 9 of the FRAT Act, which talks about international negotiations. One of the things that—this committee has had a number of oversight hearings basically on the negotiations that are going on at FSOC and then, also, the discussions that are going on with the Financial Stability Board.

As you know, in 2008, the G20 tasked the Financial Stability Board to come up with reforms for the financial system across the Board internationally. And since then, it has been kind of interesting.

Initially, the Financial Stability Board put a number of insurance companies and financial institutions, SIFIs, and subsequent to that, the FSOC made AIG and then Prudential as SIFIs.

And so the question that arises is because of the fact that the SEC and the Fed and the Treasury are all participants in the Financial Stability Board.

And so, if they are over there in those negotiations and they vote then in those discussions to make these financial institutions financially significant institutions and then they come back, can they have a fresh—do they have a fresh start then to determine from an FSOC standpoint whether they are going to be determined to be SIFIs?

And my question is—Scholar Peter Wallison with AEI said something that is inconceivable, that these designations of these three insurers would have gotten through a Financial Stability Board without express approval of the Fed and the Treasury.

So is that distorting the procedure that they are over there voting at the Financial Stability Board and then they are coming back and saying, “Okay. We are going to start over with a fresh piece of paper here and make our own determination” or is the Financial Stability Board basically making these decisions and are the Fed and the Treasury complicit to that?

Dr. Taylor, do you have an opinion on that?

Mr. TAYLOR. I don’t know the specifics of your question, but I do know quite a bit about negotiating because I was the Under Secretary of the Treasury for International Affairs for 4-plus years.

My sense is there is frequently negotiating within the government and then there is negotiating between governments. And the within government, I think as much as possible, should take the Congress into account. It doesn’t always do that.

I remember having former Chairman Barney Frank out to lunch at the Treasury to explain various things that we were working on at the time. I think that was essential.

And so I think, when you think about this legislation, the word “negotiation,” you have to think about what that means and, I think, try to explain it more. But I think, in the case you are talking about, it would be one where there should be better consultation in the first place.

But you are always going to have different opinions at different agencies. Some may be more worried about the economics. Some may be more worried about the security. Some may be more worried about U.S. competition, the competitiveness.

And they are going to figure out the best way and then approach the other government, which also has the different agencies. So, it is a complicated process.

I think the intent of the proposed legislation is fine. But I think the word “negotiation” needs some more specificity.

Mr. NEUGEBAUER. And I think one of the things that a lot of people feel like and the reason to have more transparency and disclosure here about what is going in these negotiations is because, basically, it appears that those negotiations are ending up setting policy in our own country, and I think that there is a concern about that.

And so, much like if we are negotiating treaties between other countries, basically, we are in some ways negotiating treaties between financial institutions.

Dr. Calabria, do you want to—you seem to want to engage in this.

Mr. CALABRIA. I certainly share that concern. Let me make a broader point about much of this, and this applies to the cost-benefit, this applies to the negotiation.

Congress can decide all this stuff if it wants. Remember, within Dodd-Frank, we decided that bank holding companies—there is no negotiation there. Boom. You are in. You could have decided that. The Congress could have set up other parameters.

So any of these efforts—to me, part of the problem is that Dodd-Frank has 400-some rulemakings. There is just so much delegation, so much discretion in the regulatory process, that I think some of these hard choices actually have to be made up here rather than by the regulators. But I certainly do agree.

I worry that the FSOC, the SIFI process, that—in my opinion, we are essentially signaling to the market that the entities are too-big-to-fail. I worry that is committing the Fed to assisting those entities. So I certainly think that needs to be a more transparent process.

Mr. NEUGEBAUER. I see my time has expired

Chairman HENSARLING. The Chair now recognizes the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. I agree with Dr. Calabria that Dodd-Frank basically just transferred all this power to the Executive Branch. It took us 2,000 pages to just say, "Executive Branch, don't let it happen again, and here are all the hammers to use to make that happen. Hit whoever ought to be hit." But all too often we either do nothing or we can't agree on what to do. So we just empower the Executive Branch.

I don't always agree with the Fed. They haven't focused on the trade deficit. Of course, virtually no one in Washington talks about the trade deficit. And they haven't agreed with Bernie Sanders and I that too-big-to-fail is too-big-to-exist. But very few people in Washington agree with Bernie Sanders and I on that point.

But the Fed has done more than any other institution to pull us out of the Great Recession. They have not debased our currency. It is, if anything, as shown by the inflation rate, the Cost of Living Index, as valuable as anyone would have predicted that it would be in 2014.

We have had a slow recovery, but we had a national financial meltdown. And when that happens, you expect a slow recovery, but I don't think you blame the slow recovery on Fed policy. Their low interest rates are the only thing of any policy that I can point to in the last several years that have pulled us out of this recession.

And we should approach things with a degree of humility because I don't think there is anybody in this room who can wave around a brokerage receipt showing that they were selling Countrywide short in early 2008.

If anybody really knew and was ready to bet the farm that 2008 would have happened, the least they could do is give me a ride on their private jet, subject to Ethics Committee approval.

The gentleman from New Jersey says that cost-benefit analysis was endorsed by President Clinton and President Obama.

I do think I need to point out for the record that they never supported a cost-benefit analysis for Fed monetary policy decisions because everything they do is a cost-benefit analysis.

It isn't trying to weigh debts from pollution to effects on the economy. Everything they do is to focus on the national economy. There are various cosponsors of the FRAT Act. Presidents Clinton and Obama should not be listed.

Dr. Calabria, you have suggested that we not allow people who have served in the Executive Branch within the last 5 years to serve on the Fed.

Mr. CALABRIA. Four years. That's—

Mr. SHERMAN. Should we have the same rule for those who have worked on Wall Street?

Mr. CALABRIA. In terms of people from Wall Street working at the Fed?

Mr. SHERMAN. Yes.

Mr. CALABRIA. Yes. I would be fine with a 4-year restriction. I think that is a reasonable span.

Let me say just as an aside—

Mr. SHERMAN. So we would have just academics on the Fed—

Mr. CALABRIA. No. Because—

Mr. SHERMAN. —having excluded—and former Members of Congress.

Mr. CALABRIA. If I could channel Section 10—

Mr. SHERMAN. Two of the least—

Mr. CALABRIA. If I can channel Section 10 of the Federal Reserve Act for a second, it does say, "due representation to agriculture, commerce, and industry."

So it actually—the Federal Reserve Act, as structured, suggests that we should have people—not just academics, not just bankers.

Mr. SHERMAN. I would point out there are two major problems with the structure of the Fed.

First, it is undemocratic. You have governmental power in the hands of those elected by bankers. And second, it discriminates against the western half of the country.

Certainly, if you have the San Francisco Fed representing 3 or 4 times as many people as the New York Fed, the least you could do is give the San Francisco Fed a permanent seat on the Open Market Committee, but—and perhaps I could work with the gentleman from New Jersey to correct those two problems.

Mr. Calabria?

Mr. CALABRIA. I suggest in my testimony that Section 10 of the Federal Reserve Act also requires that no two Members of the Board can be from the same Federal Reserve district.

We have repeatedly violated that. I would go as far to say that, with the current makeup of the Board and you count the New York, that the New York district has 6 votes on the FMO—

Mr. SHERMAN. And the Board that represents 3 or 4 times as many people as any other Board has either one or zero and no assurance of even one.

Finally, there is this idea, Dr. Johnson, that we could write a rule and then put monetary policy on automatic pilot if we just wrote a good rule. Is that possible?

Chairman HENSARLING. The time of the gentleman has expired.

The Chair will now recognize the gentleman from Missouri, Mr. Luetkemeyer, the vice chairman of our Housing and Insurance Subcommittee, for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

I want to go to the section that deals with the stress tests of the banks, and this really concerns me. I know that Sheila Bair wrote an op-ed back in April 2013, and the headline was, "Regulators Let Big Banks Look Safer Than They Are."

And in there she makes the comment that, "The ease with which models can be manipulated results in wildly divergent risk-weightings among banks with similar portfolios. Ironically, the government permits a bank to use its own internal models to help determine the riskiness of assets, such as securities derivatives, which are held for trading—but not to determine the riskiness of good old-fashioned loans. The risk weights of loans are determined by regulation and are generally subject to tougher capital treatment. As a result, financial institutions with large trading books can have less capital and still report higher capital ratios than traditional banks whose portfolios consist primarily of loans."

And she goes on to give an example of a big bank that has 14 percent capital, yet, if you take the risk-weighting out, it goes down to 7 percent, and then a big regional bank that is risk-weighted at 9 percent, and if you take the risk-weighting out, it stays almost the same.

So we are playing on two different fields here. And I think this part of the bill is extremely important from the standpoint of how you begin to, I think, get some of these big banks under control.

If you let them write their own stress test, if you let them write their own rules for how they exist, how in the world can we actually find a way to regulate those?

And, Dr. Calabria, I know you mention this in your testimony. Can you—

Mr. CALABRIA. I want to repeat something that Professor Johnson said, which is that the stress tests are gamed. And maybe we will agree or disagree on this, but I think they are always going to be gamed.

I think the Basel Capital Accords have been gamed. I think you see these herding into low-risk assets. Let's not forget the experts told us that Greek debt was risk-free ahead of the crisis. I think that was obviously not the case.

I really think we should abandon the stress test, abandon the Basel Capital Accords, and go to a flat, clear leverage ratio. And I think that is far more simplistic and far more transparent.

Mr. LUETKEMEYER. Okay. You don't believe that the weighting of the riskiness of the assets is something—

Mr. CALABRIA. There is always—

Mr. LUETKEMEYER. —that should be taken into consideration here?

Mr. CALABRIA. There is always going to be that issue. But I have yet to know of a financial crisis caused by small-business lending.

Yet, we know that small business is risky. We also know that the Basel Capital Accords and the stress test dissuade banks from doing small-business lending.

I think it is far more important to have a diversity of portfolios, which, to me, the stress test and the capital accords encourage homogeneity in a way that, to me, becomes systemic.

Mr. LUETKEMEYER. Okay. Along that line, what this bill does, though, is increase the transparency of those tests so at least the general public—

Mr. CALABRIA. It is a small step in the right direction.

Mr. LUETKEMEYER. Okay. That is where I was trying to go.

Yes, Dr. Johnson?

Mr. JOHNSON. Unless—

Mr. LUETKEMEYER. You talk faster than I think. So, can you slow down?

Mr. JOHNSON. Okay. I am sensitive that you have limited time.

I and Mr. Calabria agree on the capital part, and I think we are agreeing with you. And I think you are making a very important point, which is we should be putting more emphasis on leverage ratio, which is assessment of capital without these funky risk weights and less emphasis on the risk-weighted—I am not saying zero, but less emphasis.

Mr. LUETKEMEYER. Right.

Mr. JOHNSON. I think we completely agree on that.

I think you are also right and Sheila Bair is right to have concerns about anything that allows the banks to use their own models because they put all kinds of crazy stuff in that and it is not subject to very good supervision.

On the stress test proposal in this legislation, I am afraid I disagree with Mr. Calabria. I think it is a small step in the wrong direction. I think you are making it easier for the banks to game the stress test.

I agree the stress tests are not—

Mr. LUETKEMEYER. You don't believe the transparency helps in this regard? That is basically what this does here.

Mr. JOHNSON. What you have right now, Congressman, is you have transparency on the criteria of the stress test, how stressed, what is going to go wrong in the stress scenario.

What the banks want to see is the details of the models the Fed is using. Once they have those models and they run those models in their own computers, they can game them just like they game their own models. That is what you don't want.

We are agreeing on the capital, though, and I agree with what you said in the beginning: Capital is the most important thing. Capital should be front and center. And capital, without the funky risks weights, is the way to go.

Mr. LUETKEMEYER. Okay. So how would you structure that, then?

Dr. Calabria, you just indicated you just have a—

Mr. CALABRIA. I was going to say we do agree that it is a small step. The direction we might disagree on.

But again, I do think that getting more of the assumptions out there and the parameters—and I would agree. I think internal risk models are fine for the banks, but you can't use them for regulatory purposes. And I think that has to be the question here.

Mr. LUETKEMEYER. This really concerns me because I think what we are doing is we are giving the general public a level of safety here—

Mr. CALABRIA. False confidence, a level of confidence that the system is going fine, everything is good.

But when you look at what is really happening here, they are gaming the system, and I think it is really unfortunate because I don't think the American public has the true picture.

Mr. LUETKEMEYER. With that, I yield back. Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

I now recognize the gentleman from California briefly for a unanimous consent request.

Mr. SHERMAN. I ask unanimous consent to put in the record Executive Order 12866 and Section 10 thereof—

Chairman HENSARLING. Without objection.

Mr. SHERMAN. —which states that—

Chairman HENSARLING. Without—

Mr. SHERMAN. —no judicial—

Chairman HENSARLING. Without objection.

Mr. SHERMAN. —no judicial review is allowed—

Chairman HENSARLING. The—

Mr. SHERMAN. —with this Executive Order.

Chairman HENSARLING. For the unanimous consent decree, not for the pontification.

Chairman HENSARLING. The Chair now recognizes the gentleman from Washington, Mr. Heck, for 5 minutes.

Mr. HECK. Thank you, Mr. Chairman.

And thanks to all the witnesses for giving of your time today.

Dr. Johnson, I note with some interest that the proposed legislation effectively reasserts the dual mission of the Fed—namely, bringing about price stability and optimal employment levels. I am wondering, frankly, if that would be its practical effect.

I am looking back over the last 4 years as an example and have seen where, inarguably, the Fed's policies have contributed to a decline in the unemployment rate from 9 to 6 percent, and noted with interest, as revealed I think in Congresswoman Capito's question, application of this legislation would have inarguably increased interest rates over that same 4-year period of time.

What is your analysis as to what would have occurred, unemployment-level-wise, had there been higher interest rates?

Mr. JOHNSON. If the Fed hadn't taken the broad set of extraordinary measures that they embarked on in 2008, including lowering interest rates and also buying assets in a way that was at that point considered unconventional and affecting different kinds of interest rates, other than the short-term traditional policy rate, then the recession would have been deeper and unemployment would have stayed higher for longer and the recovery would have been slower.

I think that is, unfortunately, what would have happened and what would happen in a future crisis if it is the case, as I believe it is, that this legislation would effectively limit the ability of the Fed to respond fully.

Mr. HECK. So, confirming my worst fear and suspicion that it would have increased unemployment, notwithstanding the fact that it reasserts that dual mission.

There are actually other bills before the Congress that have been proposed that would have eliminated the secondary mission of optimal employment levels, which is something like a 40-year-old law on the books passed by the then-House Banking Committee overwhelmingly, with 3 dissenting votes in the United States House of Representatives. It was a bipartisan bill to set the second mission of optimal employment.

If we were to remove the optimal-employment mission from the Fed and if they were, in fact—if it were, in fact, to focus exclusively on price stability, what is your opinion and analysis as to how that would play out, if they were, in effect, not allowed to consider unemployment levels but only price stability?

Mr. JOHNSON. It depends on how they would interpret that. And there are some central banks around the world, for example, the European Central Bank, that does focus, by law, exclusively on price stability.

I think you would have less response in the case of these big downturns, certainly the financial-crisis-type situations. I don't think the Fed would embark on the same sort of creative, unconventional policies. I don't think you would have the same kind of interest rate cuts. And I think you would have higher unemployment in those situations.

Mr. HECK. So last question, if I may: Various members of this committee tend to focus on those two issues and economic indicators: price stability; and employment levels. I like them, too. But for the last couple of years, I have frankly been kind of fascinated by the output gap as an indicator. In fact, while I clearly have a problem with how it is applied in this instance, I think the fact that the output gap is a part of this formula is interesting.

And I am wondering, from your perspective, as somebody who doesn't like the approach taken in this bill, is there a way—are there policy approaches that we could take that would utilize to a greater degree the output gap as a means of driving policy?

And just to remind everybody, that is the difference between actual and potential, which is essentially a no-cost deficit to be made up in terms of the strength of the economic output, if I can use lay terms to describe it.

Mr. JOHNSON. It is a good question and a completely accurate formulation.

Look, the experts disagree a lot about this, about precisely how big is the output gap. You have to take a view on what has happened to labor force participation, as I am sure you are well aware, Congressman.

And I think this is a perfect example of why you need to delegate decision-making to the Federal Reserve. I don't think a legislative body or a committee hearing like this produces an operational answer that stands up over time. I think you need to put the right people on your decision-making Board—the FOMC, in this case.

They need to have this argument. They need to have a large staff of experts, as Chairman Hensarling has said, who need to be well-trained in a wide range of economic methodologies. And they need to hammer it out. And then they need to be held accountable, as they are in their regular hearings with you. That is the way to get at a question like that.

Mr. HECK. Thank you, sir.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Ohio, Mr. Stivers.

Mr. STIVERS. Thank you, Mr. Chairman. I appreciate your time.

I want to thank the witnesses for being here and for your testimony.

And, first, I want to give Dr. Taylor a chance to correct the record on the comments of the gentleman from California, who, I believe, a few minutes ago said that Section 7 of the bill, the cost-benefit analysis section, would require the Federal Open Market Committee to perform cost-benefit analysis on monetary policy.

And I would direct Dr. Taylor to page 15, line 8, which says, "Before issuing any regulation,". Does that mean they would have to consider a cost-benefit analysis on monetary policy?

Mr. TAYLOR. This is pretty clearly addressed to regulatory policy, in my view.

And, quite frankly, this discussion about cost-benefit analysis is amazing to me. It is sort of the basic thing you teach students about government policy. You have to pass a cost-benefit test. And, yes, it is hard; yes, it is difficult; but why would you just abandon it? It makes no sense to me, really.

Mr. STIVERS. Thank you. And that is the way I read it, too. But the way I read Obamacare, it was bad, too, so maybe different people read it differently.

But I appreciate that clarification, because I think that is really important to note. It is about the regulatory authority, and the Federal Reserve is a giant regulator in addition to the monetary policy that they pass. So I think that is really important on the cost-benefit analysis.

And, in fact, the President has an Executive Order on cost-benefit analysis that he signed; it just can't apply to independent agencies like the Federal Reserve. Therefore, an Act like this is very important. So I want to thank Mr. Huizenga and the gentleman from New Jersey for their work on it.

Second, I guess, on Section 5—and I will open this up to the entire panel—is there anyone who believes that a quarterly testimony of the Federal Reserve before Congress is overly burdensome on the Federal Reserve?

So there is one—I will take that as three people do not think it is overly burdensome and one person does.

I would just say, if we are going to have transparency in this country, having somebody be here for a few minutes every 90 days is not too much to ask. Transparency is really important, and I think this can really help.

I think there has been a lot of conversation already from previous questions on Section 2 of the bill that deals with moving to a more rule-based system.

I think I would like to ask Dr. Taylor if he remembers or wants to talk about the day when Chairman Bernanke said we might just stop quantitative easing and what happened to the markets? Do you remember what happened that morning?

Mr. TAYLOR. Yes. It was in the Joint Economic Committee, I believe. He said, maybe in the next few meetings there will be a decision and that they—sometimes called a "taper tantrum." And it did cause a lot of volatility, to be sure.

In fact, Quantitative Easing 3, it started when the long-term Treasury, 10-year Treasury was 1.7, and when he stopped talking, it was 2.7. So it is hard to see how that had a positive effect on lower rates.

Mr. STIVERS. Right.

Mr. TAYLOR. There are a lot of mistaken views about this. For one, I would just say the notion that unemployment would be higher if this legislation was passed, I believe that is completely wrong. You wouldn't have had nearly the crisis that you had, I believe, or the recession.

And that is what is, to me, a tragedy, that we went through all this and it has been a slow recovery. And, there isn't any data that say recoveries have to be slow after deep recessions. That is not American history. We have faster recoveries after deep recessions in this country. This is the most unusual slow recovery from a deep recession that we have ever had in our history that we can record.

So, those are the facts.

Mr. STIVERS. Thank you.

I would like to give Dr. Calabria and Ms. Peirce a chance to talk about Section 9, really quickly. Section 9 deals with transparency on international negotiations.

And as international harmonization becomes a bigger issue, don't you think the American public deserves to know the positions that their regulators are taking on their behalf in these international negotiations?

Either one of you?

Ms. PEIRCE. I certainly think that is important, given the role that the international negotiations are playing in determining what is happening here domestically. Obviously, you can define negotiations so that normal conversations can happen between regulators, but for the major issues, there should be some input from the public here before positions are taken abroad.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from South Carolina, Mr. Mulvaney.

Mr. MULVANEY. Thank you, Mr. Chairman.

A couple of different things: Mr. Johnson, before I get on to the questions that I wanted to ask, you mentioned something that caught my attention, several questioners back, regarding some comments that Mr. John Allison at the Cato Institute, formerly of BB&T, had made regarding suggestions he had on raising capital requirements to roughly 20 percent.

In my conversations with him on the same topic, he mentioned the same thing to me. But were you aware or was it your understanding, as it was mine in my conversations with Mr. Allison, that was part of a larger proposal, that it would allow an alternative system, that banks could opt out of Dodd-Frank, opt out of the oversight that they have today, the regulatory climate that they have, and opt into a new parallel system, where the primary, if not the only, requirement was this 20-percent capital requirement?

Was that your understanding, sir?

Mr. JOHNSON. I think I should let Mr. Calabria answer that. I just read one article. I didn't get that impression from the article. I would defer to Mr. Calabria.

Mr. CALABRIA. That is correct. It is not an add-on to the existing system. It is a much newer, simpler, and what I believe would be a safer system.

Mr. MULVANEY. Yes.

And I won't ask you, Mr. Johnson, if you are not that familiar with it, what your opinion is of it, but it might be interesting to have that conversation at some future hearing, about whether or not the idea of a parallel system—you can either maintain your lower capital requirements and operate within the existing system or opt into a parallel system that has a much more limited regulatory climate but a much larger capital requirement. We will deal with that another time.

Dr. Taylor, over the course of the last 2 years here, I have had a chance to talk to both Chairman Bernanke and then subsequently his successor, Chair Yellen, regarding the monetary tools that might be available and might not be available to the Fed as they go forward in an era of rising-interest-rates environments. And the conversation we have usually focuses on the difficulties they might have in absorbing huge balance sheet losses if they have to sell securities.

And the answer I got in response to that inquiry from both Chairman Bernanke and Chair Yellen was that the Fed could avoid having to book these losses by participating in the repo market. Subsequent to the first conversations we had in this committee about that, the Fed actually did it, or at least started that. Last September, they created the overnight reverse repurchase facility.

This committee received a letter last week, on June 30th, from Ms. Sheila Bair, the former head of the FDIC. I ask unanimous consent to place it in the record.

Chairman HENSARLING. Without objection, it is so ordered.

Mr. MULVANEY. And she has concerns about it, a lot of different concerns about it, not the least of which is whether or not it would essentially force short-term investors to reallocate their investment dollars given the presence of this new super safe investment. Would the Fed go from essentially being the lender of last resort to the borrower of first resort?

The size of this market has grown very dramatically, very quickly. And in the 2 minutes I have left, Dr. Taylor, I would ask you if you have an opinion on whether or not the Fed should be doing this and whether the Fed should be coming to Congress to ask for the ability to do this?

Mr. TAYLOR. My view is, as long as its balance sheet is so large that they have to do something when they want to raise interest rates, they are perfectly capable of raising interest on reserves for this interval, and I think that would be fine.

They are doing these other things because during the panic, they saw that the Federal funds rate actually went below the interest on reserves. And so, they are concerned that they need to do both of these things, reverse repos and interest on reserves.

But my main concern about either of these is it leads to a situation where the balance sheet may be permanently high, basically forever, call it "QE Forever," and the interest rate will be moved around either by reverse repo or interest on reserves. I think that is quite problematic.

I would like to see the Fed return to a situation where the supply and demand for reserves determines that short-term interest rate. Then, you wouldn't have all the quantitative-easing possibilities that you have currently. And, of course, to move there more quickly, it would mean they may have to sell off some of this large balance sheet. And I think if they do that in a strategic, clear way, like the second part of tapering has been, I think it wouldn't be a problem for the markets.

So I have a lot of concerns with this policy, where they are going to go, because frequently in policy, in my experience, you start out with something temporary, like temporary, 3 or 4 or 5 years, with this balance sheet so big, and it becomes a permanent one. And it is a real concern to me that the future will be "QE Forever."

Mr. MULVANEY. Dr. Calabria, you look like you have some thoughts.

Mr. CALABRIA. I was just going to say that I very much agree. I think the Fed is going to have to look at some ways to get out of this, and I think they need some flexibility in that.

And the broader point should have been they—I think they need to remember why central banks generally stay out of the long end of the yield curve to begin with. But you are in this mess now.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. Pittenger, for 5 minutes.

Would the gentleman yield to the Chair briefly?

Mr. PITTENGER. Yes, sir.

Chairman HENSARLING. It has come up a couple of times—I believe one member of the panel has said it is overly burdensome for the Fed Chair to meet with Congress on a quarterly basis. It has been well-established in the press that the Fed Chair meets with the Secretary of the Treasury on a weekly basis.

Is there any member of the panel who believes it is more burdensome to meet with Congress on a quarterly basis than with the Executive Branch on a weekly basis? Please raise your hand.

I see one.

I yield back to the gentleman from North Carolina.

Mr. PITTENGER. Thank you, Mr. Chairman.

Dr. Taylor, it often seems that anytime the Congress is contemplating an amendment to the Federal Reserve Act regarding the Fed's monetary policy requirements, we get a knee-jerk response that it will threaten the Fed's independence.

Do you feel that this is the case at this time?

Mr. TAYLOR. I think the legislation is crafted very well to prevent that. And, indeed, the Fed chooses its own policy role, and so it has the operational independence that it needs. I think that you need to go beyond the independence, and that is why I think this legislation is so valuable.

Mr. PITTENGER. Thank you.

Ms. Peirce, do you believe that putting the economic analysis requirement into the statute, like we have at the SEC and the CFTC, can have a beneficial effect on the rulemaking process and result in sounder regulatory outcomes?

Ms. PEIRCE. Absolutely. I think that the SEC has been through its own process of first ignoring its requirement, then being reminded that it should adhere to that, and then starting to employ that. And I think we are gradually seeing improved rules as a result and more deliberate rulemaking. And that is definitely needed at the Fed.

Mr. PITTENGER. Thank you.

The SEC has rules in place to ensure its employees and officials do not trade on information they learn on the job and requires them to disclose their financial investments.

Do you believe that the Federal Reserve should be exempt from these requirements, despite the fact that the Fed employees have access to sensitive, potentially market-moving information?

We will start with you, Mr. Johnson.

Mr. JOHNSON. Congressman, I had a chance to review the rules, the detailed rules, and I think the Fed circulated them more broadly, comparing the restrictions on their staff with the restrictions on the SEC. The wording is slightly different because they have, obviously, different jurisdictions, but it seemed to me to be almost exactly parallel in terms of what they can and cannot do.

And so I didn't understand that part of the legislation. I don't understand the problem that you are trying to fix there, because it seems like the Fed does have exactly the right kind of rules already. But tell me what I am missing.

Mr. PITTENGER. Mr. Calabria, would you like to respond to that?

Mr. CALABRIA. It seems like what you are simply doing is putting current Fed practice into statute. And that is great that they are doing it now, but there is no guarantee they will continue to do it. So I don't see much harm—again, maybe I should use the phrase "small step" here, because, again, it is a small step in the right direction.

Mr. PITTENGER. Sure.

Dr. Taylor?

Mr. TAYLOR. I would agree with that.

Mr. PITTENGER. Ms. Peirce, did you want to respond?

Ms. PEIRCE. Yes. I just wanted to note that part of the problem is the Fed's lack of transparency. And I think this illustrates that if they have great procedures they could tell Congress about them and get them baked into the bill.

Mr. JOHNSON. They did tell you about them. I think those details have been available for a long time. I don't understand what is the lack of transparency around these restrictions, these practices. I think they are available to Congress. I think they are available to the Chair of the committee any moment of any day that he wants to pick up the phone and call them.

Ms. PEIRCE. Yes, I think the problem is that the Fed's practice has been—and perhaps this is grounded in the fact that it was primarily established for monetary policy—to not be transparent. And so that is the pushback that Congress needs to give, because the Fed can't—it is now a massive regulator, and it can't hide behind the traditions it has built up in its monetary policy realm.

Mr. PITTENGER. Thank you.

Ms. Peirce, I would like to ask, the FRAT Act requires the Fed to provide metrics by which to gauge the success of a proposed rule, and requires the Fed to subsequently use those metrics to judge whether the rule has achieved its purpose.

Do you believe that will help to ensure new rules accomplish their intended purpose?

Ms. PEIRCE. I think that is a very important thing to do. It is important for the agency to set forth the metrics by which it will measure its own success and then a few years later to go back. Otherwise, what it will do is, when it does the retrospective review, it will just pick metrics that work well for it. So it facilitates an honest review.

Mr. PITTENGER. Dr. Calabria, did you want to—you seem like you have something on your mind.

Mr. CALABRIA. I do think that is helpful. I would also add that I think that applies across-the-board. So my general suggestion would be that everything within this committee's jurisdiction should be subject to a regular sunset so that you are forced to re-evaluate it.

Mr. PITTENGER. Thank you.

I yield back my time.

Chairman HENSARLING. The Chair now recognizes the gentleman from Pennsylvania, Mr. Rothfus.

Mr. ROTHFUS. Thank you, Mr. Chairman.

Dr. Taylor, markets responded forcefully to one of the first FOMC meeting releases to be accompanied by a press conference last summer. This panicked response occurred despite Chairman Bernanke's characterization of his comments as not substantially altering the FOMC's policy stance.

A recent survey of 55 economists by The Wall Street Journal gave the Fed a grade of D-minus for its guidance.

Don't these facts show that the Fed's monetary policy guidance function needs more work?

Mr. TAYLOR. I think so. I think the forward guidance as practiced has changed quite a bit; it has been erratic.

I would go back to the point, if they had a policy rule, like this legislation is asking, that the forward guidance would just fall out automatically. There would not be much of a question about it.

Mr. ROTHFUS. Yes.

I would like to follow up on this distinction we have been talking a little bit about between the Fed's role in setting monetary policy and the Fed's separate role as a financial regulator.

Dr. Calabria, we hear many times about the importance of the Fed's independence. Does this argument about the Fed's independence apply to the Fed's regulatory responsibilities as well as its monetary policy responsibilities?

Mr. CALABRIA. I don't think it does. And as I alluded to in my testimony, I think the fact that the Fed does bank regulation undermines its ability to conduct independent monetary policy and certainly represents some conflicts of interest.

The "Greenspan Put," the "Bernanke Put," and maybe pretty soon we will call it the "Yellen Put" came about because of the responsibility of the Fed feeling like they needed to rescue financial institutions every time there was a market hiccup. And I would certainly argue that some of the rescues, particularly of AIG, were done partly to cover up mistakes on the regulatory side that the New York Fed made.

So, to me, I just think there is a real tension here in having this entity be a central bank and a financial regulator.

Mr. ROTHFUS. As a financial regulator, should the Federal Reserve be any more independent of Congressional oversight than other financial regulators, such as the OCC or the FDIC?

Mr. CALABRIA. No.

Mr. ROTHFUS. Do any of the accountability and transparency provisions in this legislation threaten the Fed's independence to set monetary policy?

Mr. CALABRIA. In my view, no.

Mr. ROTHFUS. Okay.

Mr. CALABRIA. Let me add, it is often—I think the traditional view has felt that if we give a regulator discretion, that entails independence. And I can certainly say, as having been a regulator for a short amount of time, you get all sorts of pressure, and it is much easier to be independent if you have a set of rules to hide behind so you can sit here and say, "Well, we would love to do that for you, but this is what the law actually says."

And so, we have certainly seen this. One of the reasons that the Volcker Rule has becomes so convoluted is because it wasn't very clear to begin with. And so if you have a clear set of rules in statute, it is much easier for the regulator to defend that and stick with that than it is to compromise along the way.

Mr. ROTHFUS. Ms. Peirce, does Fed independence in setting monetary policy mean the Fed's financial regulations are above the law?

Ms. PEIRCE. Absolutely not. I think it is very important that if the Fed is going to be a regulator, and I would agree with Dr. Calabria that it should not be, but if it is going to be a big regulator, it needs to be subject to the same accountability as other regulators.

Mr. ROTHFUS. I would like to talk a little bit about the Fed's stress-test program, Ms. Peirce. The Fed's stress-test program attempts to gauge how bank balance sheets hold up in worst-case scenarios to ensure banks are prepared for periods of extended financial stress.

But wouldn't it be appropriate to also require the Fed to stress-test its own accommodative monetary policy? Specifically, shouldn't the Fed be required to stress-test its exit strategy to its quantitative easing program to estimate the effect on the Fed's ability to fulfill its mandate, the impact on the Fed's balance sheet, the upper ranges of interest on excess reserves the Fed might be required to pay, and how increases in the Federal funds rate might impact the relationship between the government's interest payments on Treasury obligations and the deficit?

Ms. PEIRCE. I am going to defer to Dr. Taylor on that since I think he has a better sense of—

Mr. TAYLOR. I think that the Fed should do all of those things.

And the evidence that they put out now that quantitative easing worked, I think, is based on studies that just looked at the announcement effect. They are not that great; they are wrong, in my view. So I think, in some sense, the answer to your question is to have these studies be done, make them public, so we can question them and analyze them and have a better debate about it.

I think when you say require them to do a specific kind of study or a specific kind of analysis, I would say that should come out of—

Mr. ROTHFUS. I guess that leads to my other question. Should the Fed be subject to transparency requirements for its own stress-test models and results?

Mr. TAYLOR. No, I think if this legislation is to work well, the Fed is going to make those things clear. That will be an example of a deviation from a policy rule, and so they are going to have to explain why they did that. So I think it would come out of the testimony.

I would hope that they would say, well, we are going to deviate because of X, and they will make it clear, their analysis. And you, being informed about it, will be able to question that, and it will be a public debate.

So I very much feel that a lot of the things that they have done recently have not been productive. They have gone ahead with them, but they have been deviations from the kind of policy for which this legislation would ask.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Kentucky, Mr. Barr.

Mr. BARR. Thank you, Mr. Chairman, for holding this very important hearing.

And thank you to the panelists.

It has been argued that there could not have been a housing bubble or the massive misinvestment in the housing market in the run-up to the financial crisis had the Fed not made the decision to expand the money supply to the extent that it did to finance the bubble in the run-up to the crisis.

The proponents of this argument make the case that the fundamental cause of the crisis was mistakes by the Fed—in other words, that it would have been impossible for a misallocation or a misinvestment of this scale to have occurred without the monetary policies pursued by the Fed before 2008.

Do the panelists agree that the Federal Reserve had a role to play in causing the financial crisis? And we will just go down the row.

Mr. TAYLOR. Yes, I do. I think that was—I would characterize it as they held interest rates too low for too long in that period, and that caused excesses in the housing market, search for yield.

I would say there are regulatory issues, as well. Rules on safety and soundness were not adhered to enough. So it is kind of breaking two kinds of rules that I think led to the crisis.

Mr. BARR. Okay.

Mr. CALABRIA. I would say, as well, that I absolutely think that monetary policy conducted about a decade ago, if you will, was a contributor of many. And to repeat what Dr. Taylor said, there certainly were other regulatory failings, some of those by the Federal Reserve, as well. For instance, to me, I think the Basel Capital Accords were a very big contributor to the crisis.

But again, there is not a mono-causal definition of the crisis. To me, a dozen different explanations all had some bearing. But I absolutely do believe monetary policy was a very big contributor, that if we had followed something like the Taylor Rule, the boom size of the housing market would have been a lot smaller.

Ms. PEIRCE. And just coming from my perspective, I would say that the Fed's regulatory policy did play a role. And that is why it is so surprising that their regulatory powers were expanded in Dodd-Frank.

Mr. JOHNSON. To answer your question, Congressman, monetary policy did contribute but in a relatively small way. The regulatory failures were much more profound. They were not just at the Federal Reserve; they were throughout the regulatory system. They were also on Capitol Hill.

And to the point that has been made previously, central banks that did not have regulatory functions also struggled, and those economies also struggled, as in Britain, as in Europe, with similar problems.

So the regulatory failure was not because of the regulations of the central bank. They were a much broader misunderstanding of what the system needed.

Mr. BARR. Okay.

And I think, Dr. Calabria, you answered this question in your initial—but the follow-up here is that to the extent monetary policy, not the regulatory side but monetary policy, was a contributing factor, was the Federal Reserve following a rule-based approach in conducting monetary policy in the years leading up to the financial crisis or following a more unpredictable model and an ad-hoc monetary policy?

Mr. CALABRIA. I certainly think in the years 2003 to about 2005, 2002 to 2005, there were large deviations from what would have been a rule, and monetary policy was certainly looser than it would have been otherwise.

But, I do want to repeat what Professor Johnson said. Certainly, there were regulatory failings across the system, as well as, I spent my time up here, and I can certainly say there were failings up here.

Mr. BARR. Professor Johnson made the argument that the legislation before this committee is monetary policy by Spanish Inquisition, that the legislation would produce volatility as opposed to prevent volatility.

I would just ask what produces a greater risk of volatility, a GAO audit of the Fed's conduct of monetary policy that deviates from a reference rule or the opaque process that led up to the financial crisis, which was characterized by a monetary policy untethered to any predictable rule day-by-day, based on the whims of the Open Market Committee?

That is a hypothetical question. Let me just take the remaining time to ask a question to Ms. Peirce really quickly on the regulatory policies of the Federal Reserve.

When we talk about applying cost-benefit analysis to the Federal Reserve, does it create a problem when the cost-benefit analysis requirements are applied to Executive Branch or independent agencies like the SEC or the CFTC but do not apply to another prudential regulator in the form of the Fed?

Ms. PEIRCE. It does create a problem. I think we saw that with the Volcker Rule, where the Fed didn't have to do an economic analysis and so we got the Volcker Rule without an analysis. And I think that across-the-board, the Fed is a very powerful regulator and needs to be contributing its analysis also.

Mr. BARR. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Florida, Mr. Ross.

Mr. ROSS. Thank you, Mr. Chairman.

Dr. Johnson, I appreciate the passion of your opening statement. And in your written opening, you indicate that everyone involved in designing and implementing monetary policy and financial regulation should ultimately be accountable, at least indirectly, to the electorate.

My question to you, first of all, is, how do you manage that? How do you make them even indirectly accountable to the electorate? Because I believe we all agree that accountability is important.

Mr. JOHNSON. Congressman, the system, as you know far better than I, that has worked well for 200 years in the American public is that you have the President nominate people, subject to Senate confirmation, and then you have regular oversight hearings of various kinds. And that is what we do for the Board of Governors of the Federal Reserve System.

It is not what we do for the Presidents of the Reserve Banks. Now, that is the result of a very strange compromise that was negotiated for the 1913 Act, and it has become, I think, increasingly problematic.

You are making some very good points about oversight and the need for oversight—

Mr. ROSS. But there should be oversight.

Mr. JOHNSON. —and there is no oversight in the New York Fed.

Mr. ROSS. It is created by Congressional empowerment; it should have Congressional oversight, period. Would you agree with that?

Mr. JOHNSON. Yes, it should, but it doesn't. I am telling you, the Reserve Banks are not subject to the same accountability as the Board of Governors.

Mr. ROSS. But all that we are—

Mr. JOHNSON. It is a big disconnect.

Mr. ROSS. All that we are proposing here is just greater transparency. We are not saying substantively these are the rules—

Mr. JOHNSON. No, here you are not addressing the main problem in the Federal Reserve System, which is the Reserve Banks.

Mr. ROSS. Let me ask you this, because they do have an independent budget. They operate with what they are able to sustain off of their investments and whatnot. But how would requiring the Fed to publish the salaries of employees who are paid at GS–15, which is $124,000 and higher, hinder that budget independence? Wouldn't it just be good transparency to know that?

Ultimately, if there is any excess in the Fed, that money has to go back to the Treasury. So I think, again, being accountable and making sure that we are accounting for all those dollars so that the Treasury gets what they are entitled to, posting something like that wouldn't be a bad thing.

Mr. JOHNSON. It is an interesting question. Are you going to require this also of the Reserve Banks? Are you going to require the salary disclosure of the executives of the New York Fed?

Mr. ROSS. What is wrong with—

Mr. JOHNSON. Because they are not paid on the same scale.

Mr. ROSS. What is wrong with requiring—sir, I only have 5—

Mr. JOHNSON. Congressman, I am answering the question.

Mr. ROSS. —minutes. I don't suffer blank air that well. It makes me a little bit impatient.

All I am saying is, in this particular situation, why not have it disclosed?

Mr. JOHNSON. I am asking—

Mr. ROSS. And you are answering with a question.
Mr. JOHNSON. I am asking—
Mr. ROSS. If you can't give me an answer, that is fine.
Mr. JOHNSON. I am asking in order to understand what you are proposing.
Mr. ROSS. Dr. Calabria, what—
Mr. JOHNSON. If you are going to include the Reserve Banks—
Mr. ROSS. This is my time, please, sir.
Chairman HENSARLING. The time belongs to the gentleman from Florida.
Mr. CALABRIA. I am going to try to answer Professor Johnson's question, which is, in my read of the Act, where it says, "the Board of Governors of the Federal Reserve System," so I think you should broaden that. To me, I think it is certainly fair to have that disclosure for the Reserve Banks. So, I am agreeing with you that they should add that, the tweak.
Mr. ROSS. Thank you.
Mr. CALABRIA. That seems a reasonable approach, to me.
Mr. ROSS. Ms. Peirce, it seems that Dr. Johnson believes that oversight, accountability, and independence are mutually exclusive. Do you agree with that?
Ms. PEIRCE. No. I think that the framework is set up where you let the folks at the Federal Reserve do their jobs but they have to explain what they are doing to the Congress and the public and get feedback—
Mr. ROSS. And explain how they are doing and why they are doing it.
And, Dr. Johnson, am I mischaracterizing your testimony, that accountability and independence are mutually exclusive?
Mr. JOHNSON. No, that is what I said in my first paragraph.
Mr. ROSS. But let me ask you this question.
Mr. JOHNSON. No, Congressman. You mischaracterized my testimony completely.
Mr. ROSS. Again, and let me ask you this question.
Mr. JOHNSON. Can I please answer the question?
Mr. ROSS. If they have a policy for setting monetary policy that includes such things as the rate of inflation, GDP, and other factors, and that is good to have as a criteria, what is wrong with disclosing all criteria used in developing and implementing monetary policy?
Mr. JOHNSON. Congressman, what has worked with regard to central banking for the past 100 years in this country and in other countries is to have the government—in this case, Congress—stipulate what the objectives are; it is up to you to determine the objectives.
Mr. ROSS. Yes, it is.
Mr. JOHNSON. If you don't like the—
Mr. ROSS. And that is what we are trying to do. We are just trying to make sure—
Mr. JOHNSON. No.
Mr. ROSS. —that we know what those objectives are that are—
Mr. JOHNSON. No.
Mr. ROSS. —being relied upon.

Mr. JOHNSON. No. Sorry, Congressman, you are going way beyond—you are going way beyond what Congress has done in the past 100 years.

Mr. ROSS. Again, I appreciate—

Mr. JOHNSON. That is your prerogative, of course, but this is radical, new—

Mr. ROSS. Dr. Taylor, quickly, I just have 40 seconds left. While I understand that international coordination is necessary—we live in a different environment than we did 5 or 10 years ago, in a global economy. But are you worried that the Federal Reserve may be prioritizing international stability over the domestic stability and regulation, with their involvement with FSOC, with their involvement with the international regulatory environment? Are we discounting our domestic regulatory environment in lieu of trying to maintain or at least gain some international control or influence?

Mr. TAYLOR. I think, to answer your question, Congressman, that the best thing the Fed can do is have a monetary policy that is good for the United States, and that is basically going to help the globe.

I think, to some extent, right now, the policy it has, has been disturbing globally. It is basically—even this so-called "taper tantrum" had impacts all over the world, and that comes back and hurts the United States.

So it does make sense to think about U.S. monetary policy as having effects abroad and worrying about those because they feed back onto the United States. I think it is very important.

Mr. ROSS. Thank you, Dr. Taylor.

I see my time has expired.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Illinois, Mr. Hultgren.

Mr. HULTGREN. Thank you, Mr. Chairman.

And thank you all for being there.

As we all know, in the wake of recent financial crises, the Federal Reserve has absolutely accumulated a vast amount of unprecedented power to oversee our economy. Its balance sheet alone has grown to a staggering $4.3 trillion, one-fifth of the economy, and it has also grappled with an expanded array of regulatory duties.

My constituents demand that the Fed account for its handling of these important issues. That is just common sense. After all, Fed policy affects every aspect of our Main Street economy, from the price of daily essentials like gas, milk, and bread, to the cost of a home and the strength of seniors' retirement savings.

The Federal Reserve must remain an independent agency that can withstand political threats to that independence, but this bill does not tell the Fed when or how to do its job. It just requires that the Fed take a transparent, measured approach to doing so. An independent Fed shouldn't equal an opaque Fed.

These sensible reforms could bring the accountability to the Federal Reserve that the American people demand. And I thank the committee for taking up this legislation.

I want to focus, in my question time, on the stress-test provision in the bill. Stress tests can be a very important way to show that large financial institutions can, in fact, withstand an economic downturn. This reduces the likelihood of future bailouts because they encourage companies to follow safe and sound business practices. They also convince our Nation's policymakers that the proverbial sky will not fall during an economic downturn.

However, I am also deeply concerned about the highly secretive and unpredictable nature of the stress-testing process. The Fed doesn't have to follow the notice-and-comment process, too often focuses on unpredictable qualitative factors, and doesn't provide banks with a detailed accounting of the stress-test methodology. In practice, banks respond by constraining their lending, which hinders the economic recovery that my constituents desperately need. This legislation addresses those concerns.

Some, such as our distinguished panelist, Dr. Johnson, worry that this legislation undermines the efficacy of the stress test. He believes it will make it easier for other companies to tailor their balance sheets to Fed methodologies, gaming the system.

I wonder, can the remaining panelists explain why companies won't improperly game the system? For example, if the Fed believes in its stress-test model and that passing banks are safe and sound, why shouldn't there be transparency? I would ask the other three if you have a response?

Mr. TAYLOR. I think the reforms improve the ability of the stress test to work.

I do think that it needs to be supplemented with these leverage ratios or with a combination of the risk-weighted capital requirements. And, in fact, the more I think about these issues that you are raising—"too-big-to-fail" resolution, Title 2 of Dodd-Frank, Chapter 14—the more I realize that a simpler way would be to just get these capital requirements at a more satisfactory level.

Mr. CALABRIA. So let me parse out where I think I very much agree with the questions and then maybe where I have some concerns.

Where I very much agree is that our system is very procyclical, in my opinion. I think we let booms get out of control, and I think during the busts we clamp down too hard and end up—I think our current regulatory system ends up being, again, exacerbating the swings. That needs to be addressed.

I don't necessarily think the biggest problem in that is the stress tests. As I mentioned earlier, I am very skeptical of the stress tests. I would abandon them altogether, quite frankly. I don't think they are very informative, in my opinion. Then again, I don't actually think they are very stressful.

So that point is, again, I would just drop the stress tests altogether and focus on simpler, more transparent ratios, like a leverage ratio.

Mr. HULTGREN. Ms. Peirce, a quick thought?

Ms. PEIRCE. You could enhance the credibility of the stress tests by making them more open so people knew what the models were, what the assumptions were, and then people could comment on whether they thought those were strong enough or not. We saw in Europe that people didn't believe the stress tests were very credible there. And so you could have stronger ones.

But I also worry that the banks are spending so much time worrying about what assumptions, what data the Fed is using in its models that they are not worrying about the real business realities that they are facing as a bank. And if we don't believe that bankers can manage their own banks without the Fed walking them through it, I think we are in a really bad place. We can't rely on regulators to run our banks.

Mr. HULTGREN. I just have about 30 seconds left. I wanted to talk quickly about the cost-benefit analysis on all regulation that I believe is necessary.

I wonder, Dr. Taylor, does the Fed's independence require that the Fed be exempt from a review of its rules by the courts? Does Fed independence in setting monetary policy mean that the Fed's financial regulations are above the law?

Mr. TAYLOR. I think cost-benefit analysis applied to the regulatory doesn't sacrifice the Fed's independence. Other agencies do that. I think it makes sense.

Mr. HULTGREN. Thank you very much.

My time has expired. I yield back, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

There are no other Members in the queue. Thus, I would like to thank each one of our witnesses for their testimony today.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing stands adjourned.

[Whereupon, at 12:43 p.m., the hearing was adjourned.]

A P P E N D I X

July 10, 2014

QUESTIONS
FC – "LEGISLATION TO REFORM THE FEDERAL RESERVE"
JULY 10, 2014
REP. JOYCE BEATTY, OH-03

- Thank you Mr. Chairman and Madam Ranking Member.

- I've been in this Committee for 18 months now, and in that time I've heard quite a bit about cost-benefit analysis.

- We've had bills, hearings, and markups where we've gone back and forth on the importance of cost-benefit analysis, and the negative outcomes associated with failing to complete one before finalizing a decision.

- But as much as we've talked about it, I sometimes wish we could expand the scope beyond the regulators, to include some of the decisions that have been made around here in the few short months since I've arrived in Congress.

- It would be interesting to consider what we'd find if we were to do a cost-benefit analysis on:

  1. Refusing to reauthorize the Export-Import Bank which is directly and indirectly responsible for creating hundreds of thousands of American jobs;

  2. Completely removing government support from the housing finance market, which would reduce the availability of mortgages for many qualified buyers, and would negatively impact our economy;

  3. Failing to properly fund through the appropriations process, the SEC and CFTC – two of the regulators who have been charged with preventing the next economic catastrophe;

  4. Overturning rulemakings and preventing enforcement actions by the CFPB, which is responsible for stopping, or compensating victims of, financial fraud;

5. Failing to invest in early education programs that help give our young people a competitive edge in the global economy;

6. Failing to support workers' rights and paycheck fairness which have been found to have direct correlations with productivity and employee turnover;

7. Refusing to extend emergency unemployment insurance for the millions of Americans who are still struggling to get back on their feet, and the local businesses that depend on them as customers;

8. Opposing funding for the nutrition title in the Farm bill, which directly harms low-income American families and American farmers;

9. Failing to support comprehensive immigration reform, which negatively effects American businesses' ability to hire and retain top talent from around the world;

10. Opposing environmentally-sound emissions regulations which, in the long-run, harms our children and grandchildren;

11. Failing to invest in transportation infrastructure through the Highway Trust Fund, which is essentially bankrupt, and would be responsible for the elimination of up to 700,000 decent American jobs if not funded immediately;

12. Supporting corporate tax relief, but opposing renewal of important individual tax credits which would mean help for businesses but not the people who work in them;

13. Advocating *against* gun control in even minimal ways such as mandatory background checks, which puts a strain on our nation's healthcare system, in addition to wreaking havoc in our inner cities and suburbs;

14. Opposing an increase to the minimum wage which has failed to keep pace with inflation over the past four decades;

15. Supporting the continuation of the sequester which hurts our seniors, children, service-members and veterans;

16. Failing to protect the foundation of our Democracy – voting rights, and free and fair elections – when they are under attack in many states and in the Supreme Court;

And of course:

17. Shutting down the government and threatening default on our nation's debt, in a misguided attempt to repeal the law of the land: the Affordable Care Act.

- If we are going to be supportive of cost-benefit analyses let's not just do so selectively.

- I oppose this legislation for the many reasons already discussed such as the Fed's loss of independence, the imprecise nature of economic modeling, and the inappropriateness of disclosing non-political, career public-servants' salaries.

- I thank the witnesses for their time today and yield back.

- Thank you.

Testimony of Mark A. Calabria, Ph.D.

Director, Financial Regulation Studies, Cato Institute

Before the

Committee on Financial Services

United States House of Representatives

Hearing entitled "Legislation to Reform the Federal Reserve On Its 100-Year Anniversary"

July 10, 2014

Mark A. Calabria, Ph.D. is Director of Financial Regulation Studies at the Cato Institute. Before joining Cato in 2009, he spent seven years as a member of the senior professional staff of the U.S. Senate Committee on Banking, Housing and Urban Affairs. In that position, he handled issues related to housing, mortgage finance, monetary policy, economics, banking and insurance. Prior to his service on Capitol Hill, Calabria served as Deputy Assistant Secretary for Regulatory Affairs at the U.S. Department of Housing and Urban Development, and also held a variety of positions at Harvard University's Joint Center for Housing Studies, the National Association of Home Builders and the National Association of Realtors. He has also been a Research Associate with the U.S. Census Bureau's Center for Economic Studies. He holds a doctorate in economics from George Mason University.
http://www.cato.org/people/mark-calabria

Testimony of Mark A. Calabria, Ph.D.

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Hearing entitled "Legislation to Reform the Federal Reserve On Its 100-Year Anniversary"

July 10, 2014

Chairman Hensarling, Ranking Member Waters, and distinguished members of the Committee, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a non-profit, non-partisan public policy research institute located here in Washington, D.C. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official positions of the Cato Institute. In addition, outside of my interest as a citizen and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

Let me first commend the Chairman, along with Subcommittee Chair Campbell, on the establishment of the Federal Reserve Centennial Oversight Project. Every government program should be reviewed regularly and subjected to vigorous oversight. The American people deserve nothing less. I can think of no part of the federal government more in need of review than the Federal Reserve.

It should also be clear that review and oversight of the Federal Reserve is likely to be insufficient. Legislative change of the Federal Reserve's structure, powers and operating procedures is badly needed. While neither I nor the Cato Institute endorse specific pieces of legislation, as a general matter, I do believe the general principles behind the "Federal Reserve Accountability and Transparency Act of 2014" are sound and admirable. My testimony will touch upon the various sections of this legislation, offering both minor technical and substantive changes, as well as broader changes that should be considered.

"Federal Reserve Accountability and Transparency Act of 2014"

Sec. 2 Requirements for Policy Rules of the Federal Open Market Committee; Limited Fed GAO Audit Requirement

It has long been accepted in the economics profession that discretionary monetary policy has an "inflation bias". The problem is that in the short run "surprise" inflations by a central bank can produce increases in employment and output. Over time, however, market participants come to anticipate this inflation with employment and output reverting to baseline. The result is higher inflation but no long-run improvement in either employment or output. To the extent that inflation distorts relative prices, economic efficiency is lost and the increased level of inflation can result in reduced employment and output. We saw such an outcome arise here in the U.S. in the 1970s.

It is not surprising that the 1970s also witnessed a re-birth[1] in the economic debates over rules versus discretion in monetary policy[2], most associated with the work of Kydland and Prescott[3], Calvo[4], McCallum[5], as well as that of Barro and Gordon[6]. As my fellow panelist, John Taylor, was an important active contributor to that debate[7], there is probably little I could add to his insights in this area. I will however make a few observations about the issue that bear some emphasis.

First, all policy decisions are based upon models. To take action A one must believe that outcome B will result. That's a model. Generally policymakers do not explicitly state the parameters of their model, but such does not imply there is no model. In terms of monetary policy, the existence of the Fed's "dual mandate" implies a particular model as to the effect of monetary policy. Of course to have a model is not necessarily having an accurate representation

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[1] For an overview of earlier debates see Robert Hetzel (1985), "The Rules versus Discretion Debate Over Monetary Policy in the 1920s," *Economic Review*, Federal Reserve Bank of Richmond; and George Tavlas (2014), "In Old Chicago: Simons, Friedman and the Development of Monetary-Policy Rules," Becker Friedman Institute, University of Chicago, Working Paper #2014-02.

[2] For an overview of this literature see Chapter 7 of Carl Walsh (2010) *Monetary Theory and Policy*, 3rd edition, the MIT Press; as well as Alesina, A. and A. Stella (2010), "The Politics of Monetary Policy," *Harvard Institute of Economic Research* Discussion Paper #2183.

[3] Kydland, F. and E. Prescott (1977), "Rules rather than discretion: The inconsistency of optimal plans," *Journal of Political Economy*, 85, 473-490.

[4] Guillermo Calvo (1978), "On the Time Consistency of Optimal Policy in a Monetary Economy," *Econometrica*, Vol. 46, No. 6 (Nov), pp. 1411-1428.

[5] McCallum, Bennett (1984), "Monetarist Rules in the Light of Recent Experience," *American Economic Review* 74: 388-91.

[6] Barro, R. and D. Gordon (1983), "Rules, Discretion, and Reputation in a Model of Monetary Policy," *Journal of Monetary Economics*, 101-121; and Barro, R. and D. Gordon (1983), "A Positive Theory of Monetary Policy in a Natural-Rate Model," *Journal of Political Economy*, 91.

[7] See among others, John Taylor (1985) "What Would Nominal GNP Targeting Do to the Business Cycle?" *Carnegie-Rochester Conference Series on Public Policy* 22: 61-84.

of reality. Many models used in economics are quite elegant and well constructed, yet lack much semblance to reality. Whether stated explicitly or not, and whether accurate or not, the Federal Reserve is currently operating under a particular policy model of our economy.

What Section 2 of the bill under consideration does is require the Federal Reserve to reveal that model to the rest of us. Section 2 does not require a specific model. In no way does it limit the Fed's choice of model. It simply requires that the Fed publicly share that model. All of the Fed's actions in recent years would have still been possible had Section 2 been in place. There is nothing in Section 2 that is inconsistent with the Fed's "dual mandate". Nor is there anything in Section 2 that would require the Fed to raise (or lower) rates. There is no compromise of the Fed's operational independence.

Why is it important to reveal the Fed's current operating model? So that it can be examined and tested by those outside the Fed. Only under such examination can we learn how accurately that model captures the real world. Forcing the Fed to specify and reveal its operating model would push the Fed to be clearer in its deliberations and better focus the conduct of monetary policy.

My own criticism of Section 2 is that it leaves the Fed with too much discretion. Again there is nothing in Section 2 that requires the Fed to make different choices. For instance one issue which led the Fed astray in the past is its estimate of potential GDP. As former Obama economic advisor Christina Romer and her husband have noted, one of the Fed's mistakes in the 1960s was in assuming a very large potential GDP relative to actual GDP.[8] Similar debates are

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[8] Christina Romer and David Romer (2002), "The Evolution of Economic Understanding and Postwar Stabilization Policy," in *Rethinking Stabilization Policy*, Federal Reserve Bank of Kansas City, pages 11-78,

happening today. The process of the Fed learning from its 1960s mistakes was a costly and painful one. With greater transparency over the Fed's decision-making, we may avoid having to incur those large costs again.

In summary, while I would place tighter constraints on Fed decision-making, Section 2 as drafted represents a significant improvement in transparency and accountability for the Federal Reserve that has considerable potential to improve the quality of decision-making at the Fed.

Sec. 3. Federal Open Market Committee Blackout Period

While I believe the Federal Reserve's current blackout period, in which members of the FOMC do not engage in public appearances, is generally a wise policy, I also believe the concerns expressed in Section 3 of the bill are very real. At times the Fed's current blackout policy has been used as a cover to ignore Congressional inquiries and stymie Congressional oversight. I can think of no reason that the Fed's current blackout period apply to prudential or supervisory matters. Allowing discussion of such matters, as does Section 3, is a useful clarification that can improve Congressional oversight of the Fed's regulatory efforts.

Sec. 4. Transparency of Stress Test and Regulatory Activities

Stress tests have become a central feature of the Federal Reserve's oversight of large financial institutions. These stress tests have been developed largely as private negotiations between the largest banks and the Federal Reserve. Given their increased importance, and often questionable assumptions, I believe it is crucial that the parameters and structure of the stress tests be subject to a public rulemaking process.

Although the stress tests are advertised as an avenue for reducing systemic risk, I am very concerned that as practiced they may actually increase it. First, I believe the financial crisis demonstrated, among other things, the failure of a heavy reliance on mathematical modeling. The Fed stress tests continue to rely upon a number of questionable statistical assumptions, such as normality, that have been shown to underestimate tail risk. The stress tests run a very real risk of being a substitute for sound risk management rather than a complement.

Perhaps the greatest danger from the stress tests is that they encourage greater uniformity across bank balance sheets. We have seen how the Basel Capital Accords have encouraged banks to herd into similar assets, such as mortgage-backed securities and sovereign debt. When everyone is a holder of a particular asset, there are few buyers when everyone wants to be a seller. This can contribute to the severity of fire sales and cause shocks to particular asset classes to become systemic when they would otherwise not. A more robust financial system would be one with a greater diversity of asset holdings, business models and funding sources. The stress tests are encouraging greater homogeneity in our financial system. Perversely the Stress Tests themselves may become a significant source of systemic risk. The Cato Institute will shortly release a policy paper detailing many of the failings of the current stress tests[9]. Greater congressional and public input may help to reduce this risk.

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[9] Kevin Down (forthcoming) *Math Gone Mad: Regulatory Risk Modeling by the Federal Reserve.* Cato Institute Policy Analysis.

Sec. 5. Appearances before the Congress

Given the central role of the Federal Reserve in our financial markets and larger economy, coupled with its lack of transparency and accountability, increased congressional oversight of the Federal Reserve is crucial. The shift in Section 5 from a minimum twice yearly to quarterly congressional testimony for the Federal Reserve Chair would help to improve communications between Congress and the Federal Reserve.

Such a change would be particularly important to more junior members of the Committee. Generally the committee chair and ranking member will have some regular access to the Federal Reserve Chair. Such access is not evenly shared across the Committee. To some extent that is to be expected and appropriate. Additional scheduled Federal Reserve Chair appearances, however, would help to "democratize" the Committee's relationship with the Federal Reserve.

It would also help to strengthen the Federal Reserve's independence from the executive branch. The Federal Reserve Chair generally meets on a regular basis with the Treasury Secretary. It would be an understatement to say that the Federal Reserve has often acted as an adjunct of the executive branch in recent years. This behavior has greatly undermined the Federal Reserve's independence from the executive branch. Section 5 would offer a small step in helping to restore that balance and independence.

Sec. 6. Vice Chairman for Supervision Report Requirement

The Section 6 requirement that the Federal Reserve's Vice Chairman for Supervision report on pending and anticipated rulemakings would be a welcomed change. Such a report would allow greater public awareness of Federal Reserve rulemakings and hopefully encourage a greater diversity of public commentary on those rules. It would also be useful if this report on pending and anticipated rulemakings was concurrent with the testimony published in the Federal Register.

Sec. 7. Economic Analysis

As a general matter we as a society should prefer that regulations be structured in such a manner, within the statutory discretion given, that maximizes benefits and minimizes costs to society and not simply select parties. Obviously all policies are subject to both costs and benefits. There are no "free lunches" in terms of either regulation or statute. As the Committee is aware, the Federal Reserve is not required by statute to conduct cost-benefit analysis. It should be. Cost-benefit analysis also nudges regulators to state the assumptions behind the regulations in question. This allows clear thinking about the impact of such regulations.

First the Federal Reserve clearly has the capacity. The Federal Reserve Board employs hundreds of Ph.D.-level economists. The regional Federal Reserve Banks also employ hundreds. Perhaps only the USDA has more economists on staff. So clearly there isn't a lack of staff available and capable of performing cost-benefit analysis. The Federal Reserve should and could do so today.

Some might object that requiring the Federal Reserve to conduct cost-benefit analysis would slow or stifle the regulatory process. Similar concerns were expressed when the Administrative Procedures Act was passed in the 1940s. That notice and comment would slow the process. That public input would slow the process. One could argue that having two houses of Congress slows the legislative process. But our objective should not be speed but quality. All too often in Washington, policymakers sacrifice deliberation and diligence for speed. The question should be: would cost-benefit analysis improve the quality of regulations issued?

After decades of cost-benefit analysis conducted by agencies other than the financial regulators several things should be clear. First, the requirement of cost-benefit analysis has not brought the regulatory state to a standstill. Look at the Environmental Protection Agency if you want to see how cost-benefit analysis has not stopped an agency from issuing expansive, costly regulations. Second, cost-benefit analysis has expanded the parameters of the regulatory debate and forced agencies to consider a broader range of options than they would have otherwise. Given how badly the Federal Reserve suffers from groupthink, anything that forces the consideration of a greater diversity of options is likely to improve the process.

To be effective we must insure that cost-benefit analysis within an agency is independent of the rule-making process. Too often agencies have allowed the program offices writing and implementing regulations to oversee the cost-benefit analysis. In some agencies the General Counsel's office has directed the cost-benefit analysis. The conflict of interest here should be blindingly obvious. I would add to Section 7 a requirement that cost-benefit analysis within the Federal Reserve be conducted by an independent office within the Federal Reserve and be reported directly to members of the Board.

Sec. 8. Salary Disclosure, Office Staff of the Fed Board & Ethics Requirements

The salary disclosure and ethics requirements in Section 8 strike me as reasonable and representative of what other regulators are subject to. The disclosure burden also strikes me as quite minimal.

Of greater importance is Section 8's requirement that each Federal Reserve Board member have their own dedicated staff, with a minimum of two members. This is the norm for many agencies, such as the Securities and Exchange Commission,so there's certainly nothing unusual here. Given the Chair's control over the Federal Reserve staff, I believe allowing each board member to have some dedicated staff would help those members engage in Federal Reserve decision-making in a more informed manner. Such would allow a greater diversity of viewpoints to be heard in Board meetings. Such a change could help reduce some of the groupthink that so dominates the Federal Reserve. This would be particularly important for non-economists on the Board who are forced to rely heavily upon the staff economists and defer to Board members who are economists. Likewise the economists on the Board would benefit from having dedicated legal staff to help them interpret relevant statutes and regulations. I see this change as perhaps one of the more important in the bill and one that should be relatively uncontroversial.

Sec. 9. Requirements for International Negotiations

Given the secretive nature of international negotiations on financial regulations, and the prevalence of groupthink among the World's financial regulators, I believe the disclosure requirements of Section 9 are badly needed. Section 9 would assist Congress and the public in providing greater oversight of the international negotiations of financial regulators, helping to insure that a greater diversity of voices is heard outside the financial establishment.

Some Additional Suggestions

A number of the provisions of the "Federal Reserve Accountability and Transparency Act of 2014" would improve the decision-making process at the Federal Reserve without mandating a particular outcome. To some extent these provisions do so by increasing the diversity of perspectives incorporated into the Federal Reserve's monetary and regulatory policy-making process. I believe the Federal Reserve suffers from substantial groupthink and is badly in need of vigorous and open debate. The narrow views that dominate the Federal Reserve must be expanded if we are to avoid future harm to our economy.

In that spirit, I would suggest the Committee consider the following additional provisions: Section 10 of the Federal Reserve Act establishes a variety of qualifications for Board membership, including a requirement for geographic diversity. That requirement has regularly been ignored. I find it troubling that several members of the Board hold position in direct violation of Section 10 of the Federal Reserve Act. Section 10 has been violated in the past with tortured definitions of residency that effectively render the statute a dead letter. Most recently, when MIT Professor Peter Diamond was nominated, it was claimed that a single lecture he delivered at Northwestern University made him a Chicago resident. Such disrespect for the law would be laughable if it were not so damaging. I would urge the Committee to clarify the geographic residency qualifications of Section 10 of the Federal Reserve Act. Doing so would allow a greater portion of our country to be represented on the Board, as opposed to the usual Wall Street dominance of the Federal Reserve Board.

The independence of the Federal Reserve from the executive branch has greatly been eroded over time by the revolving door between the Federal Reserve and economic policy-makers in the executive branch, particularly the Treasury Department and the President's Council of Economic Advisors. I would suggest the Committee institute a ban on Federal Reserve Board membership for any person holding an appointed position in the executive branch in the four years preceding the appointment.

While several provisions of the "Federal Reserve Accountability and Transparency Act of 2014" would improve the supervisory and rule-making process at the Federal Reserve, I believe we should ultimately remove the Federal Reserve from the area of financial regulation. Their track record in that area has not exactly been impressive. I would suggest the Committee transfer the Federal Reserve's financial regulatory and supervisory responsibilities to the Federal Deposit Insurance Corporation (FDIC). While the FDIC has had it failings, they pale in comparison to those of the Federal Reserve. Recent scholarship has also found that separating banking supervision from monetary policy leads to better outcomes both in terms of macroeconomic and financial stability.[10] Removing financial regulatory responsibilities from the Federal Reserve would also increase its independence in the area of monetary policy. The so-called Greenspan "put" was an expectation by markets that Fed liquidity would be provided whenever financial markets were stressed. If the Fed has responsibility for the health of financial

[10] See Barry Eichengreen and Nergiz Dincer, *Who Should Supervise? The Structure of Bank Supervision and the Performance of the Financial System*, NBER Working Paper No. 17401 September 2011 http://www.nber.org/papers/w17401

institutions it faces the temptation to use monetary policy to offset its regulatory failings, reducing the ability of financial markets to weed out poorly managed firms.

Some may object to the proposals offered in the bill under debate. The mostly likely objection is that it undermines the ability of "experts" to pursue the "correct" policies free of political independence. This view ignores that the so-called experts at the Fed had vast discretionary powers before the crisis and failed to use them. Regulators did not lack for powers. They lacked for wisdom. They lacked for proper incentives. And of course they lacked for information and knowledge. Our founding fathers rightly rejected the view that we should be governed by experts insulated from politics (that is democracy). The great strength of American government is its checks and balances. Exempting the Fed from these checks and balances will lead to worse outcomes not better.

Conclusions

I want to again thank the Chairman and Ranking Member for the invitation to appear at today's important hearing. There are few parts of the federal government with less transparency and accountability than the Federal Reserve. This is all the more troubling given the Federal Reserve's outsized role in our economy. Its failings have inflicted substantial harm on our labor market, our financial markets and the financial health of American households. Without substantial reform, the Federal Reserve is almost certain to continue its record of failure.[11] I applaud the Committee for holding today's hearing and for its effort to improve the functioning of the Federal Reserve. I can think of few issues more pressing.

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[11] George Selgin, William D. Lastrapes, Lawrence H. White, "Has the Fed been a failure?", *Journal of Macroeconomics*, Volume 34, Issue 3, September 2012, Pages 569-596

Testimony submitted to the House Financial Services Committee, Hearing on "Legislation to Reform the Federal Reserve on Its 100-Year Anniversary," at 10am on Thursday, July 10, 2014. Embargoed until the hearing starts.

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of http://BaselineScenario.com.[1]

A. **Summary Points**

1) All prosperous industrial democracies have a central bank that has considerable operational independence, combined with a reasonable amount of democratic accountability. Experience over the past 100 years and across a wide range of countries has repeatedly demonstrated the paramount importance of creating a buffer between officials appointed to control monetary policy and elected politicians. At the same time, everyone involved in designing and implementing monetary policy and financial regulation should ultimately be accountable, at least indirectly, to the electorate.
2) Effective independence for monetary policy involves and requires:
    a. Fixed term appointments, without the possibility of being dismissed or pressured out over policy disagreements. In the US, for example, this means 14-year terms for members of the Board of Governors of the Federal Reserve System.[2]
    b. The ability to make day-to-day decisions, sometimes under significant time pressure, without risk of being overruled by another branch of government.
    c. Limits on the extent of judicial review. For example, courts cannot rule that interest rates in the US (or other industrial democracies) have been set in an unreasonable way or at an inappropriate level.
    d. Budgetary independence – the Fed's budget is not a Congressional appropriation.
3) As much as possible, monetary policy and financial regulation should be conducted free of partisan or political influence. Interest rates should not be set with an eye on the electoral cycle.[3]

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[1] Also a member of the private sector Systemic Risk Council, a member of the Congressional Budget Office's Panel of Economic Advisers, and a member of the F.D.I.C.'s Systemic Resolution Advisory Committee. All views expressed here are personal. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide regular updates and detailed policy assessments for the global economy. For additional affiliations and disclosures, please see this page: http://BaselineScenario.com/about/.

[2] In modern America, most Board governors serve for considerably less than 14 years – and new governors are then appointed to fill incomplete terms. For more details and some history, see Peter Conti-Brown and Simon Johnson, "Governing the Federal Reserve System after Dodd-Frank," Peterson Institute for International Economics, Policy Brief 13-25, October 2013.

[3] For example, Paul Volcker's ultimately successful effort to bring inflation under control was made possible by the independence of the Federal Reserve System.

4) The Board of Governors of the Federal Reserve System also regulates an important part of the financial system, including (under Dodd-Frank) any firms or activities that could pose systemic risks. Large financial institutions, especially those seen as "too big to fail", typically oppose meaningful limits on their activities. They are particularly opposed to limits on their ability to increase leverage (i.e., to have a large amount of assets relative to their equity). As executives at these banks are usually paid based on their return on equity, not fully adjusted for risk, such an approach generates substantial expected private benefits. There are also substantial negative externalities from such a high leverage strategy, but these are not internalized by any one financial firm.[4]
5) In the U.S. since 2008, very large bank holding companies have resisted: the Volcker Rule, more restrictive capital requirements, a tighter cap on leverage, and other changes. They have also pushed back against many CFTC rules on derivatives and they continue to resist SEC changes on a variety of issues.
6) The U.S. has long handled monetary policy and financial regulation by appointing experts, subject to oversight by relevant politicians (e.g., through Senate confirmation, appearances at hearings in the Senate and in the House, and through being subject to reappointment.) The goals for these experts are stipulated by law and are kept simple. Other industrial democracies follow a similar approach – and over time have moved towards some aspects of US practice, although there are differences across countries in the weights attached to various objectives.
7) These experts need to have the ability to act in a responsive manner. As the economy and financial system change, officials must be able to adjust policy appropriately.
8) The Federal Reserve Accountability and Transparency Act (H.R. 5018), as currently drafted, would impose undue and excessive constraints on the ability of officials to respond fully and in a timely manner to changing economic and financial circumstances. Section B below explains my concerns in more detail.
9) The U.S. does have an unusual governance structure for monetary policy, relative to other leading central banks. In our Reserve Bank structure, bankers have a great deal of potential influence over the presidents on those banks – and these individuals serve on the Federal Open Market Committee (on a rotating basis, apart from the president of the New York Fed, who is a permanent member). In this way we have allowed private sector bankers to have much more potential sway over interest rates than is commonly the case in other high income countries today.
10) Section C of this testimony suggests that, if Congress is seeking to improve the governance of the Federal Reserve System, the New York Fed would be the best place to start. The

[4] For more on the economics of incentives around high leverage and the case for higher capital requirements, see Anat Admati and Martin Hellwig, *The Bankers' New Clothes*, Princeton University Press, 2013. See also the speeches and analytical work published by Tom Hoenig, vice chairman of the Federal Deposit Insurance Corporation (FDIC):
http://www.fdic.gov/about/learn/board/hoenig/capital.html, and
http://www.fdic.gov/about/learn/board/hoenig/capitalizationratios4q13.pdf (his Global Capital Index).

president of the New York Fed is one of the most powerful officials in the US (and the world). He (or she) is vice chairman of the FOMC and has a lead role in implementing monetary policy and in public debt management (effectively on behalf of the Treasury). This person has also played been important in deciding whether or not to bail out (or to force a "bail in") for particular sets of investors – and negotiating the detailed terms for such transactions. The president of the New York Fed should be a presidential appointment, subject to confirmation by the U.S. Senate. The operations of the New York Fed should not be under the control of a board of directors selected or suggested by financial institutions.[5]

B. Specific Comments on Proposed Legislation[6]

The Federal Reserve Accountability and Transparency Act, as currently drafted, appears to have three main goals. First, to put pressure on Federal Reserve policymakers to follow a specific monetary policy rule – stipulated in detail by Congress – that would determine interest rates, rather than allowing them to use their own best judgment. In part this would be achieved through the mechanism of "audits" of the Fed's monetary policy decision-making by the Government Accountability Office (GAO), acting under the direction of congressional committees.

The second goal is to require that the Fed publish all details of its regular stress tests for banks. And the third goal is to ensure that the Fed implement a particular form of cost-benefit analysis when it draws up regulatory rules.

There are some other smaller changes in the current draft, for example regarding the testimony that should be provided by the vice chairman for supervision, and requirements that should be fulfilled before entering into international negotiations.

I take up each of these points in turn below.

Monetary Policy Rule

Modern central banks put great emphasis on clear communication, both for their objectives and their actions. The Federal Reserve is no exception.

The proposed legislation heads in a different direction by attempting to specify in detail what should be the default rule determining monetary policy (i.e., the level of policy-controlled interest rates) and by establishing some narrow and very specific criteria for this rule.

The proposed framework raises the following specific questions:

[5] New York has an appropriate interest in ensuring that its particular regional economic concerns are represented, but the way to do that is through an economic advisory committee -- not through a board of directors that has or appears to have a role in selecting management or overseeing the work of the reserve bank, including its employees, policies, and research.
[6] This section is responding to the version of June 30, 2014 (3:05pm), which I was sent by the committee.

a) What happens when measures of GDP are updated or revised, as happens with some regularity?
b) What is "the monetary aggregate" referred to the proposed new directive policy rules; Sec. 2C(a)(4)(C)(ii)?
c) In the calculation of the reference policy rate, what happens when real GDP is above potential GDP? Similarly, what happens when there is deflation (falling price level)?
d) What exactly is meant by "stable prices"? Similarly, what is the precise meaning of "maximum natural employment over the long term"?

The mechanism for the GAO audit is specified in some detail, and seems designed to put pressure on the Federal Reserve's Open Market Committee. The potential effect is likely to be chilling, creating obstacles to productive work and bringing more partisan pressure to bear.

If the GAO determines that the actual policy being followed is not in compliance with the framework specified here, the chairman of the Federal Reserve System must testify within 7 legislative days on this point.

The most unclear part of the proposed legislation is probably the section on the GAO audit, which says "the Comptroller General shall audit the conduct of monetary policy," and that this should be "upon request of the appropriate congressional committee." Also, I note that "Such committee may specify the parameters of such audit."

This would introduce a great deal of uncertainty into monetary policy making. What would be the criteria for such an audit? When and how exactly would those criteria be set? Would they vary across audits? What would be the effect or implications of such audits? Do they end up becoming some sort of repeated quasi-prosecutorial fishing expedition, with every single interest rate move being investigated?

The net effect on financial markets would be to increase volatility. This would presumably discourage investment and depress economic activity relative to what it would be otherwise.

Stress Tests

Recent rounds of stress tests have had some success in identifying weaknesses, both in the balance sheets and risk-management tools of large complex financial institutions.

These firms are now pushing back, arguing that they would like all details of the stress test requirements and related models to be published in advance – and moving away from any dimension of qualitative assessment. Large bank holding companies also want to force the Fed to disclose all aspects of its models, so that employees at these banks can more effectively game what they put in their submissions for the stress tests.

The legislative approach proposed here is not appealing, as it has the potential to turn the stress tests from a potentially useful tool determining capital adequacy to an uninformative boxchecking exercise. Even worse, if large financial institutions can find grounds for making a process complaint against the Fed, they will be able to use this to slow down or obstruct all forms of decision-making that have the potential to reduce the level of systemic risk.

Cost-Benefit Analysis

The legislation would create the onerous burden of a particular form of "cost-benefit analysis," along the lines of what the industry has tried to impose on regulators such as the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).[7] As drafted, the legislation also appears to impose this kind of cost-benefit analysis on monetary policy decision-making.

Any well-functioning central bank, such as the Federal Reserve, considers the pros and cons of its actions. And the Fed's senior officials explain and defend its policies on a regular basis, in speeches, testimony, and in other formats.

For example, in formulating the recently finalized Volcker Rule—a process involving the Fed and other agencies—there was an extended period for comments, and a great deal of interaction between officials and the industry.

The cost-benefit analysis proposed here would slow down all forms of rule-making. Although this is not specified explicitly, it would presumably also open up decisions of the Federal Reserve's Board of Governors to broader judicial review. As we have seen with regard to other regulators, this can make it much harder to implement rules effectively and with any reasonable degree of certainty.

The legislation also stipulates that the regulators could find that "no regulation" is their preferred option. This could directly contradict congressional legislation that requires regulation on a particular issue. Regulators are supposed to work out the details of how to implement what Congress has decided; it is not their job to second-guess elected legislators on what should or should not be in the law.

There is also an important asymmetry in this "cost-benefit" process, from a legal perspective. In a typical instance, representatives of industry write many comment letters in which they claim there would be various costs – sometimes with considerable exaggeration. If the regulators do not take all of these details seriously (after all, this is a form of paid lobbying), they are sued by

[7] For an assessment of why such analysis is not required and how it would impede SEC regulation, see "Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC," a report by Better Markets, July 30, 2012. The same is true regarding CFTC rulemaking, as set forth in the Amicus brief filed by Better Markets in an industry challenge to a CFTC rule: https://www.bettermarkets.com/sites/default/files/DTCC%20v%20%20CFTC%20(DDC)%20Better%20Markets%20Amicus%20Brief%20For%20Filing.pdf. Litigation over applying cost-benefit analysis to the SEC and CFTC has had the effect of slowing down the design and implementation of rules required or implied by the Dodd-Frank Act.

the industry. However, if the regulators err on the side of the industry and impose rules that are too weak or ineffective, members of the public cannot generally sue – as they lack standing, despite the fact that they would benefit from an effective rule (e.g., the Volcker Rule, which limits proprietary trading and some other forms of excessive risk-taking that can damage the economy, including employment and other outcomes that matter a great deal for individual members of society).

"Cost-benefit analysis" of this precise form is therefore a legal ploy that tilts the playing field towards the industry. The goal is to create potential technical faults that can allow the courts to determine that the rule was not written properly or with full consideration for the industry opinions that were expressed. This slows down the regulatory process and makes it much more cumbersome – as has been the experience at the SEC and the CFTC. For example, failing to cite a study that was commissioned by the industry – and that did not have credible findings – can be enough to overturn a rule (or to send it back for more work).

The courts do not have the expertise or, under current interpretation, the mandate to assess the substance of cost-benefit analysis. This is purely about creating a procedural hurdle.

On these points, the net effect and perhaps unintended consequence of the legislation would be mostly to add red tape and procedural obstacles that will make it harder to operate effectively. This includes all forms of post-adoption assessment specified here in cumbersome detail. Adding such paperwork requirements is one way to ensure that bureaucracy and the size of government expands in an unproductive manner. This is not a good idea in general or an appealing approach to central banking.

In this context, it is striking, and a little odd, that the potential impact on price stability – and the Fed's ability to achieve such price stability – is not mentioned, for example under "additional considerations".

And any assessment of costs and benefits should definitely include the probability of a significant financial crisis, along the lines of what we experienced in 2008.[8] We should be careful not to put equal weight on all jobs created – for example, if these are of a purely rent-seeking nature or the result of massive, opaque, implicit government subsidies, they are presumably of less value from a social perspective.

To be effective, our central bank must retain some flexibility. Top experts should be and are appointed to the Board of Governors. They need to be allowed to do their job.

[8] The costs of the last crisis were around one year's GDP. For more details, see this report by Better Markets, http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis_2.pdf.

Vice Chairman for Supervision

The Dodd-Frank Act requires that "The Vice Chairman for Supervision shall appear before the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives and at semi-annual hearings regarding the efforts, activities, objectives, and plans of the Board with respect to the conduct of supervision and regulation of depository institution holding companies and other financial firms supervised by the Board."

The legislation adds the requirement that if this position is vacant, the other vice chairman (or the chairman) should testify instead. This does not seem unreasonable.

We definitely need to make progress with regard to filling the position of vice chair for supervision at the Federal Reserve Board.[9] We also need this person to push forward with key parts of implementation for Dodd-Frank, including making the "living wills" for large financial institutions into something that can actually be used in a meaningful way (Title I), and ensuring that we have workable resolution procedures in case a large bank holding company fails (Title II). In this context, we need a funding structure for bank holding companies that is comprised primarily of "loss-absorbing" liabilities – preferably in the form of common equity.

International Negotiations

The legislation seeks to impose a longer and more formal comment period, in the event that the Federal Reserve or the FDIC wants to enter into international negotiation.

Given the importance of cross-border issues for potential resolution of failing financial institutions, imposing such a requirement would make it harder to put in place any kind of workable regime. This would be most regrettable as it would make it harder to fully end any notion that some firms are "too big to fail".

Large firms are also opposed to effective cross-border capital requirements, particularly those focused on leverage (i.e., without using risk-weights). As currently drafted, the legislation would assist large international banks in resisting sensible capital regulation.

More generally, international standards for banks and some other financial institutions are now being raised. The industry is determined to slow this process down as much as possible.

[9] For more on this specific point, see the paper by Peter Conti-Brown and Simon Johnson, cited in footnote 2 above.

C. Governance and the Federal Reserve System[10]

The current draft of this legislation does not address what may be the most important current governance issue within the Federal Reserve System: the appointment and responsibilities of the president of the Federal Reserve Bank of New York. At the heart of this issue is an unfortunate anachronism – the mechanism that determines who sits on the board of directors of the New York Fed.[11]

The New York Fed staff is comprised of smart, highly professional people who work hard to make the financial system more stable. At the same time, both the New York Fed and the Fed's Board of Governors, which is responsible for all aspects of how the New York Fed operates – including who sits on its board – seems to have developed a tin ear with regard to governance issues and how these can threaten the Fed's independence.

As with all other regional Federal Reserve Banks, the New York Fed's board, working with senior staff members, picks potential board members, all of which are subject to approval by the Fed's Board of Governors in Washington.

Senator Jack Reed of Rhode Island addressed this issue during the debate on Dodd-Frank in 2010,[12]

> "Although the Senate bill included my proposal to require the head of the Federal Reserve Bank of New York to be Presidentially appointed and Senate confirmed, the provision was stripped out during conference. If the Governors of the Federal Reserve System in Washington are required to be confirmed by the Senate, then the President of the Federal Reserve Bank of New York, who played a pivotal and perhaps more powerful role in obligating taxpayer dollars during the financial crisis, should also be subject to the same public confirmation process. Wall Street should not have the ability to choose who is in such a powerful position. Although the final bill limits class A directors--who represent the stockholding member banks of the Federal Reserve District--from participating in the process, it still allows the other directors, who could be bankers or represent other powerful interests, to vote for the head of the New York Reserve Bank. I believe that more still needs to be done to make this position truly accountable to the taxpayers."

[10] Governance issues at regional Federal Reserve Banks, including the composition of their boards of directors, were raised in an earlier version of the Federal Reserve Accountability and Transparency Act (H.R.3928): http://thomas.loc.gov/cgi-bin/query/F?c113:1:./temp/~c11378f0UD:e25955:, which proposed to eliminate Class C directors.

[11] For more details on the evolution of governance at the Fed over time and the importance of the 1935 Banking Act in this regard, I recommend the forthcoming book by Peter Conti-Brown, *The Structure of Federal Reserve Independence* (Princeton University Press, 2015).

[12] See http://www.reed.senate.gov/news/speech/floor-statement-on-the-dodd-frank-wall-street-reform-and-consumer-protection-act.

Senator Reed's analysis remains correct on all points. The president of the New York Fed occupies an office with great powers, both with regard to monetary policy – as vice chair of the FOMC and as a key implementer of FOMC policy – and with regard to regulation (as the eyes and ears of the Fed system on Wall Street). He (or she) also matters for fiscal policy – a Treasury function – because the New York Fed serves an important interface between the official sector and the market for government debt. These are not powers that rotate among other regional Fed presidents.

Under Dodd-Frank, Class A directors (bankers representing bankers) no longer participate in the selection of regional Fed presidents. But Class B directors are non-bankers elected by bankers (supposedly to represent the public). And the Class C directors at the New York Fed have, with some prominent exceptions, been noticeably close to big banks.

Class C directors should become more independent of the banking sector – their responsibility is to watch out for the economy as a whole, not for one specific interest group. This could be achieved by the Board of Governors shifting its criteria for the people who become Class C directors, particularly at the New York Fed. Abolishing Class C directors would not be a good idea, as this would put more hands in Class B directors, who are appointed by the banks.

In addition, it would be much more consistent with best practice internationally and elsewhere in our political system if the president of the New York Fed were to be appointed by the president of the United States, subject to confirmation by the U.S. Senate.

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TESTIMONY

LEGISLATION TO REFORM THE FEDERAL RESERVE ON ITS 100-YEAR ANNIVERSARY

BY HESTER PEIRCE

Committee on Financial Services, US House of Representatives

July 10, 2014

Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to be here today. I welcome the chance to discuss some of the potential effects of this legislative proposal to reform the 100-year-old Federal Reserve. I will focus my remarks on the portions of the proposed legislation that relate to the Federal Reserve's role as a regulator and supervisor of financial institutions—an area in which its ambitions outstrip its capabilities. Reform is needed to curb the Federal Reserve's expansive regulatory approach, which threatens to increase instability in the financial system. Reform should include increased congressional oversight, enhanced transparency, greater internal discipline, and a larger role for public participation.

WHY REFORM IS NEEDED

The Federal Reserve now actively seeks to secure for itself an increasingly large and interventionist role in regulating and supervising financial institutions, rather than concentrating on monetary policy. This aggressive and expansive regulatory approach relies on government control of the financial system, undermines private firms' ability to manage themselves, and threatens to destabilize—rather than to secure—the financial system. Attempts to oversee the Federal Reserve's regulatory functions clash with its deep traditions of opacity and independence developed in the monetary policy context.

The Federal Reserve's Expansive Regulatory Role

The Federal Reserve's regulatory powers are far-reaching. Dodd-Frank expanded the Federal Reserve's regulatory jurisdiction, and Board and regional bank officials frequently make the case for further expansion.[1] The Fed's stable of regulated entities includes banks, bank holding companies, foreign banking organizations, savings and loan holding companies, supervised securities holding companies, financial market utilities, and systemically important financial institutions. The Federal Reserve chairman, through her membership on the

1. For a discussion and illustration of that growing role, see Hester Peirce and Robert Greene, "The Federal Reserve's Expanding Regulatory Authority Initiated by Dodd-Frank" (infographic, Mercatus Center at George Mason University, Arlington, VA, November 2013), http://mercatus.org/sites/default/files/The-Federal-Reserve-Expanding-Regulatory-Authority.pdf.

Financial Stability Oversight Council, participates in selecting the financial market utilities and systemically important financial institutions that are subject to Federal Reserve regulation.

The Federal Reserve has embraced an assertive post-crisis regulatory and supervisory approach. As has become the vogue among central bankers, the Federal Reserve has turned to macroprudential regulation, an approach that highlights financial stability. The Federal Reserve views itself as a sort of central planner charged with ordering the activities of private participants in the financial system to preserve systemic stability.[2] Because the objectives are not limited to the stability of any particular institution, financial institutions may be directed to take steps that are for the purported good of the system, even if those steps are not in the best interests of the institution in question. Chair Janet Yellen recently explained that macroprudential policy is often a superior substitute for monetary policy in the pursuit of financial stability, but that "adjustments in monetary policy may, at times be needed to curb risks to financial stability."[3] This linkage raises questions about whether the Federal Reserve may try to use monetary policy tools to cover up supervisory missteps.

To drive bank behavior in its favored direction, the Federal Reserve uses—among other tools—the Dodd-Frank Act stress tests (DFAST) and the Comprehensive Capital Analysis and Review (CCAR), which includes quantitative and qualitative components. The Federal Reserve's use of stress testing, which grew out of crisis-era initiatives to determine how much capital banks needed are well intentioned, but the Federal Reserve's nontransparent approach to stress testing is flawed. For example, it does not publicly divulge the supervisory models pursuant to which it assesses banks.

Rather than dealing with business realities, banks must guess at the supervisory hypotheticals and qualitative criteria against which they will be assessed. The consequences of getting it wrong are severe—a negative result on the stress test harms a bank's reputation and stock value.[4] Given the high stakes, trying to figure out what is of concern to the regulators becomes a higher priority than identifying and managing actual operational, business, and market risks.

Federal Reserve staffers are indirectly and subtly reshaping the banking system with their models, scenarios, and assumptions. These may be flawed, colored by inappropriate influence from favored banks, or inadequately tailored to banks' unique circumstances. As we have seen in other contexts, regulatory directives can drive unhealthy market behavior and undermine the stability of the financial system.[5]

The Federal Reserve's Opacity and Lack of Accountability

The lack of transparency and accountability is not limited to stress testing. The Federal Reserve's regulatory approach, perhaps informed by its tradition of monetary policy independence, is at odds with the widely accepted principles of transparency and public participation that should govern agency activities. The Federal Reserve does not adhere to its own directive requiring for most rules that economic analysis be conducted and available to the public and that meetings to consider the rules be public.[6]

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2. For a discussion of the difference between micro- and macroprudential regulation, see Andrew Crockett, General Manager, Bank for International Settlements, Chairman, Financial Stability Forum, "Marrying the Micro- and Macro-prudential Dimensions of Financial Stability" (speech, September 21, 2000), http://www.bis.org/review/rr000921b.pdf. Mr. Crockett explains, "To bring out the contrast, think of the financial system as a portfolio of securities, ie, the individual institutions. The macro-prudential perspective would focus on the overall performance of the portfolio; the micro-prudential vision would give equal and separate weight to the performance of each of its constituent securities."
3. Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, "Monetary Policy and Financial Stability" (speech before the International Monetary Fund, July 2, 2014), http://www.federalreserve.gov/newsevents/speech/yellen20140702a.htm.
4. Stephanie Armour, Dan Fitzpatrick, and Ryan Tracy, "Fed Kills Citi Plan to Pay Investors," *Wall Street Journal*, March 26, 2014, http://online.wsj.com/news/articles/SB10001424052702303325204579463652083306902.
5. See, for example, Stephen Matteo Miller, "Long Live Risky Finance?" *Economic Intelligence* (blog), *US News & World Report*, June 23, 2014, http://www.usnews.com/opinion/economic-intelligence/2014/06/23/why-are-cdos-and-structured-notes-making-a-comeback; Roberta Romano, "For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture," *Yale Journal on Regulation* 31 (2014): 1–76.
6. Board of Governors of the Federal Reserve System, Statement of Policy Regarding Expanded Rulemaking Procedures, 44 Fed. Reg. 3957 (1979).

The Federal Reserve is not subject to the regulatory analysis standards that add a measure of transparency and accountability to government agencies' rulemaking. Along with most federal financial regulators, the Board of Governors of the Federal Reserve System is an independent regulatory agency.[7] The significance of this categorization is that the Federal Reserve is not subject to the executive orders that have required most regulators to conduct regulatory impact analysis for more than three decades.[8] As a consequence, extensive new regulatory obligations are being imposed on the financial sector and passed on, at least in part, to consumers of financial services without consideration of their benefits, costs, and unintended consequences.

The Federal Reserve's new emphasis on macroprudential regulation could exacerbate accountability and transparency problems if the Federal Reserve cites the link with monetary policy to assert its independence in connection with its macroprudential regulatory activities. Governor Daniel Tarullo, acknowledging that the Federal Reserve has not disclosed its supervisory models in connection with the DFAST and CCAR, pointed to alternative forms of "oversight and accountability"—an internal group of model validation experts and the six external experts on the Model Validation Council.[9] Internal staff reviews and a handful of outside experts are not a substitute for broader public engagement.

The Federal Reserve actively engages with its international counterparts. Cross-border dialogue is important, given the global nature of our financial markets. Domestic regulators, however, are not authorized to delegate domestic regulatory decisions to multinational groups of regulators. Agreements made abroad—whether at the Basel Committee or at the Financial Stability Board (FSB)—are not automatically binding in the United States, but in practice are highly influential on domestic regulatory outcomes. FSB members, for example, commit to implement international standards.[10] The Federal Reserve's active participation in the FSB raises concerns that it will use the FSB to steer domestic policy.[11] International discussions are not an appropriate substitute for the notice-and-comment rulemaking process, which is designed to elicit and incorporate public comment.

WHAT CAN BE DONE?

Under Dodd-Frank, the Federal Reserve enjoys considerable discretion in choosing which financial institutions it will regulate and how it will regulate them. Such broad discretion, however, risks undermining the Federal Reserve's credibility. In order for the Federal Reserve to be a more effective regulator, it needs to be subject to greater oversight by the public and Congress. Its regulatory and supervisory approaches should be governed by consistent, reasonable procedures that are transparent to regulated entities, their investors and creditors, and the customers they serve.

Congressional Oversight

The Federal Reserve would benefit from greater congressional oversight, particularly because the budget for its regulatory activities is outside the congressional appropriations process. One way to enhance accountability would be to require more frequent appearances by the Federal Reserve chairman. Oversight would also be enhanced by a specific congressional focus on the Federal Reserve's regulatory agenda. Dodd-Frank attempted to do this through the creation of a presidentially nominated and Senate-confirmed Vice Chairmanship for Supervision.[12] The persistent vacancy in that position during a period of active rulemaking has impeded congressional oversight. Measures to ensure that the Federal Reserve keeps Congress apprised of upcoming rules, regardless of whether the Vice Chairman position is filled, would facilitate congressional oversight and public transparency.

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7. "Independent regulatory agencies" are enumerated in 44 U.S.C. § 3502(5).
8. For a discussion of federal financial regulators' limited economic analysis obligations, see Hester Peirce, "Economic Analysis by Federal Financial Regulators," *George Mason Journal of Law, Economics & Policy* 9 (2013): 569–613.
9. Daniel K. Tarullo, "Stress Testing after Five years," (speech at the Federal Reserve Third Annual Stress testing Modeling Symposium, June 25, 2014), http://www.federalreserve.gov/newsevents/speech/tarullo20140625a.htm.
10. Financial Stability Board, *FSB Framework for Strengthening Adherence to International Standards*, June 9, 2010, http://www.financialstabilityboard.org/publications/r_100109a.pdf.
11. Governor Tarullo, for example, currently serves as chairman of the FSB's Standing Committee on Supervisory and Regulatory Cooperation.
12. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1108, 124 Stat. 2126 (amending 12 U.S.C. § 242).

Enhanced salary disclosures and ethics rules for Federal Reserve employees would reflect the increasingly important role that they play in reshaping the financial markets. Current salary figures, of course, must be viewed in the context of future earning potential. A recent Federal Reserve Bank of New York study found evidence in support of the idea that bank regulators "have an incentive to favor complex rules because 'schooling' in these regulations enhance regulators' future earnings, should they transition to the private sector."[13]

Discipline, Transparency, and Public Participation in Rulemaking

Requiring the Federal Reserve to conduct and make available for public comment economic analysis in connection with its rules would add transparency and accountability to its regulatory functions. Doing so would improve the quality of rules by incorporating insights from the public, and any resulting "marginal delay in writing a rule likely is a fraction of the time the rule will be in place."[14] In practice, such a requirement would cause the Federal Reserve to undertake several common-sense steps before adopting a rule: (1) identify a problem that requires intervention by the Federal Reserve and alternative ways to solve that problem, (2) study the costs and benefits of each reasonable solution, and (3) identify metrics to facilitate a retrospective review to make sure the rule is achieving its objectives effectively and without harmful unintended consequences.

Another way to improve the Federal Reserve's regulations is by soliciting public comment in the period before the Federal Reserve enters into deliberations with its international counterparts. Such a pre-comment period would not be a substitute for the comment period during notice-and-comment rulemaking, but it would enable the Federal Reserve to enter international discussions with the benefit of public input on the subject at hand. Given the degree to which international negotiations serve as the basis for subsequent Federal Reserve rulemaking, affording the public an opportunity for early input would greatly enhance the Federal Reserve's regulatory transparency and accountability.

Internal Dialogue

External input would improve Federal Reserve rulemaking, but internal dialogue among the members of the Board of Governors—each of whom brings different expertise to the job—is also important. Allowing each member to have her own staff would enrich the internal discussion. The member's staffers would be able to pursue issues she perceives to be of particular importance, rather than being reliant on the general Federal Reserve staff that answer to the chairman. Other agencies, such as the Securities and Exchange Commission and the Commodity Futures Trading Commission, allow each commissioner to have dedicated staff.

CONCLUSION

As the Federal Reserve celebrates one hundred years, reform efforts are timely. Consideration of fundamental questions about the Federal Reserve's role in the regulatory landscape and in the markets should accompany those efforts.[15] Specifically, Congress should consider the propriety, efficacy, and danger of the Federal Reserve's current regulatory and supervisory approach—one in which a group of politically unaccountable staffers uses imprecisely defined discretion, unwritten standards, and complex rules to reshape the banking system. Congress also should consider the potentially harmful implications of centralizing and homogenizing banks' strategic, managerial, and risk determinations. Finally, Congress should look for alternative ways of addressing concerns about systemic instability and contagion. These might include removing the government guarantees that weaken

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13. David Lucca, Amit Seru, and Francesco Trebbi, "The Revolving Door and Worker Flows in Banking Regulation," Federal Reserve Bank of New York Staff Report No. 678 (June 2014), 4, http://www.newyorkfed.org/research/staff_reports/sr678.pdf.
14. Abby McCloskey and Hester Peirce, "Holding Financial Regulators Accountable: A Case for Economic Analysis," (American Enterprise Institute, Washington, DC, May 2014), http://www.aei.org/papers/holding-financial-regulators-accountable.
15. Some of those questions were asked in Renee Haltom and Jeffrey M. Lacker, "Should the Fed Have a Financial Stability Mandate? Lessons from the Fed's First 100 Years," *Federal Reserve Bank of Richmond 2013 Annual Report* (2014), https://www.richmondfed.org/publications/research/annual_report/2013/pdf/article.pdf.

private risk management, introducing mechanisms that reward private risk monitoring, and replacing regulators' model-based rules with simple standards.

Thank you for the opportunity to be here today. I look forward to your questions.

ABOUT THE AUTHOR

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Requirements for Policy Rules for the Fed

Testimony Before
The Committee on Financial Services
United States House of Representatives

February 11, 2014
John B. Taylor*

Chairman Hensarling, Ranking Member Waters, and other members of the Committee on Financial Services, thank you for the opportunity to testify at this hearing on HR 5018, "The Federal Reserve Accountability and Transparency Act." In this written testimony I will focus on the first main section of the Act entitled "Requirements for Policy Rules for the Federal Open Market Committee."

The Need for Legislation

Research by many people over many years has shown that predictable rules-based monetary policy is essential for good economic performance. It leads to price stability. It leads to overall economic stability, and it creates conditions for strong steady employment growth and productivity growth. My own research going back more than four decades supports this view, and such a view has become embedded in macroeconomic theory thanks to the work of Robert Lucas, Finn Kydland, Edward Prescott and others.[1]

And the research continues today: At a conference last spring at Stanford's Hoover Institution George Shultz, Allan Meltzer, Marvin Goodfriend, Michael Bordo, Richard Clarida. David Papell, John Cochrane, Lee Ohanian, William Poole, Jeffrey Lacker, and Charles Plosser all spoke about the advantages of a rules-based monetary policy.[2] The view that monetary policy rules work is also supported by historical and statistical evidence. During periods when policy is

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[1] John B. Taylor, "Estimation and Control of a Macroeconomic Model with Rational Expectations," *Econometrica*, 47 (5), September 1979, 1267-1286; Robert E. Lucas, "Econometric Policy Evaluation: A Critique," in *The Phillips Curve and Labor Markers*, Karl. Brunner and Allan Meltzer (Eds.) Amsterdam: North-Holland. 1976; Finn Kydland and Edward C. Prescott, "Rules Rather Than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy*, 1977, 85. 473-493. For a summary of this and succeeding research see John B. Taylor and John C. Williams "Simple and Robust Rules for Monetary Policy," in Benjamin Friedman and Michael Woodford (Eds.), *Handbook of Monetary Economics,* Elsevier, 2011, 829-859.

[2] Frameworks for Central Banking in the Next Century, May 28-30, 2014, http://www.hoover.org/events/frameworks-central-banking-next-century

more rules-based as in much of the 1980s, 1990s and until recently, the economy has performed well. During periods such as the 1970s and the past decade when policy has been more interventionist and discretionary, economic performance has been poor. That the shifts in policy preceded the shifts in economic performance is compelling evidence that the changes in policy have been a cause of the changes in economic performance.

Central bank independence alone has not prevented the departures from steady rules-based policy. Robust indices of de jure central bank independence show virtually no change in the past 50 years.[3] In other words within a given legal framework, policy makers have been able to engage in varying degrees of adherence to rules-based policy. Indeed these very swings from rules to discretion—especially the swing from rules to excessive intervention in the past decade—demonstrate the need for legislation requiring the Fed to adopt rules for setting its policy instruments.[4]

For these reasons, the new requirements for policy rules for the Fed put forth in Section 2 of the "Federal Reserve Accountability and Transparency Act of 2014," are most welcome.

On the "Requirements for Policy Rules for the Federal Open Market Committee"

The legislation is well-designed and well-balanced. It takes account of the research described above and the practical experiences with monetary policy during the history of the Federal Reserve and other central banks.

It incorporates different views about the instruments and transmission process of monetary policy while maintaining throughout the important principle that central bank decisions should be based on strategy or a rule with limits placed on discretion and excessive intervention in a transparent and accountable way.

It builds on lessons learned from experiences with earlier legislative initiatives requiring reporting on the monetary policy instruments, including the requirement to report ranges for the monetary and credit aggregates which were removed from the Federal Reserve Act by the American Homeownership and Economic Opportunity Act of 2000.

It allows the Fed to serve as lender of last resort or take appropriate actions in the event of a crisis.

It provides appropriate and effective Congressional oversight without micromanaging the operations of the Fed or reducing its operational independence to choose a monetary strategy.

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[3] Christopher Crowe and Ellen E. Meade, "The Evolution of Central Bank Governance around the World," *Journal of Economic Perspectives*, Vol. 21, No. 4, 69–90, 2007

[4] John B. Taylor, "Legislating a Rule for Monetary Policy," *The Cato Journal*, 31 (3), Fall, 407-415, 2011.

It thereby meets the goal enunciated by Milton Friedman many years ago of "legislating rules for the conduct of monetary policy that will have the effect of enabling the public to exercise control over monetary policy through its political authorities, while at the same time it will prevent monetary policy from being subject to the day-by-day whim of political authorities."[5]

In particular, the Act would require that the Fed "submit to the appropriate congressional committees a Directive Policy Rule... which shall describe the strategy or rule of the Federal Open Market Committee for the systematic quantitative adjustment of the Policy Instrument Target to respond to a change in the Intermediate Policy Inputs." Thus, the rule would describe how the Fed's policy instrument, such as the federal funds rate, would change in a systematic way in response to changes in the intermediate policy inputs, such as inflation or real GDP. The rule would also have to be consistent with the setting of the actual federal funds rate at the time of the submission.

It is important to note that under the proposed legislation the Fed, not the Congress, would choose its Directive Policy Rule and how to describe it. But if the Fed deviated from its rule, then the Chair of the Fed would have to "testify before the appropriate congressional committees as to why the [rule] is not in compliance."

The legislation also creates a transparent process for determining if the rule is in compliance: The Comptroller General of the United States would be responsible for determining whether or not the Directive Policy Rule was in compliance and report its finding to Congress.

The legislation provides flexibility. Of course, the policy rule itself does not require that any instrument of policy be fixed, but rather than it flexibly adjusts in a systematic and predictable way to economic developments. Moreover, the legislation allows for the Fed to change its rule or deviate from it, if the Fed policy makers decide that is necessary. "Nothing in this Act shall be construed to require that the plans with respect to the systematic quantitative adjustment of the Policy Instrument Target be implemented if the Federal Open Market Committee determines that such plans cannot or should not be achieved due to changing market conditions." But "Upon determining that plans...cannot or should not be achieved, the Federal Open Market Committee shall submit an explanation for that determination and an updated version of the Directive Policy Rule."

The legislation also requires that the Fed's report to the congressional committees "include a statement as to whether the Directive Policy Rule substantially conforms to the Reference Policy Rule" along with an explanation or justification if it does not. "The term 'Reference Policy Rule' means a calculation of the nominal Federal funds rate as equal to the sum of the following: (A) The rate of inflation over the previous four quarters. (B) One-half of the percentage deviation of the real GDP from an estimate of potential GDP. (C) One-half of the

[5] Friedman, Milton (1962), *Capitalism and Freedom*, University of Chicago Press, Chicago, p 53.

difference between the rate of inflation over the previous four quarters and two. (D) Two. This is the Taylor Rule.[6]

This requirement will not put any undue burden on the Fed and it usefully makes a connection between the Fed's analysis and that of many in the private sector. Describing the difference between a policy rule being investigated and this particular "reference rule" is a task undertaken routinely by researchers working on different policy rules, so it is a straightforward task for the Fed. In fact, many at the Fed already make such comparisons including Fed Chair Janet Yellen.[7] Of course the legislation does not require the Fed to follow any particular rule, but only to describe how the Fed's rule might differ from this reference rule.

There is precedent for the type of Congressional oversight in the proposed legislation. Previous legislative language, which appeared in the Federal Reserve Act until it was removed in 2000, required reporting of the ranges of the monetary aggregates. The legislation did not specify exactly what the numerical settings of these ranges should be, but the greater focus on the money and credit ranges were helpful in the disinflation efforts of the 1980s. When the requirements for reporting ranges for the monetary aggregates were removed from the law in 2000, nothing was put in its place. A legislative void was thus created concerning reporting requirements and accountability. In many ways the proposed legislation fills that void by replacing the reporting requirements for the policy instruments that were then removed from the Federal Reserve Act.

Conclusion

In sum HR 5018—including the section on policy rules I discussed here and the later sections on cost-benefit analysis and transparency—promises to improve greatly the operation of monetary policy in the United States and thereby lead to better economic performance, especially compared to much of the past decade.

Of course, some will likely object to the legislation, including some at the Fed. But based on writings, speeches, and publically released transcripts of meetings, we know that many at the Fed favor a more rules-based policy either now or in the future. Informed and constructive comments from the perspective of the Fed would undoubtedly improve the legislation, but if the proposed legislation were passed into law, I am sure the policymakers and the staffs in the Federal Reserve System could make it work to a good end.

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[6] John B. Taylor, "Discretion Versus Policy Rules in Practice," *Carnegie-Rochester Series on Public Policy, North-Holland*, 39, 1993, 195-214 and Center for Economic Policy Research Publication No. 327, Stanford University, November 1992

[7] Janet Yellen, "The Economic Outlook and Monetary Policy, Money Marketeers, New York, New York April 11, 2012

into account both the need for long-run sustainability and the fragility of the recovery. Doing so earlier rather than later would help reduce uncertainty and boost household and business confidence.

Finally, on monetary policy, in view of the weaker economic outlook, subdued projected path for inflation, and the significant downside risk to economic growth, the FOMC decided to ease monetary policy at its June meeting by continuing its Maturity Extension Program, or MEP, through the end of this year. The MEP combines sales of short-term Treasury securities with an equivalent amount of purchases of longer-term Treasury securities. As a result, it decreases the supply of longer-term Treasury securities available to the public, putting upward pressure on the prices of those securities and downward pressure on their yields, without affecting the overall size of the Federal Reserve's balance sheet. By removing additional longer-term Treasury securities from the market, the Fed's asset purchases also induced private investors to acquire other longer-term assets such as corporate bonds and mortgage-backed securities, helping to raise their prices and lower their yields, and thereby making broader financial conditions more accommodative.

Economic growth is also being supported by the exceptionally low level of the target range for the Federal funds rate from zero to one-fourth percent and the economy's forward guidance regarding the anticipated path of the funds rate.

As I reported in my February testimony, the FOMC extended its forward guidance in January, noting that it expects that economic conditions, including low rates of resource utilization and a subdued outlook for inflation over the medium run, are likely to warrant exceptionally low levels for the Federal funds rate at least through late 2014. The Committee has maintained this conditional forward guidance at its subsequent meetings. Reflecting its concerns about the slow pace of progress in reducing unemployment and the downside risk to the economic outlook, the Committee made clear at its June meeting that it is prepared to take further action, as appropriate, to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability. Thank you, Mr. Chairman. I would be happy to answer your questions.

[The prepared statement of Chairman Bernanke can be found on page 54 of the appendix.]

Chairman BACHUS. Thank you, Chairman Bernanke. Next week, the House will be voting on Dr. Paul's bill to audit the Federal Reserve. Would you please give us your views on the legislation?

Mr. BERNANKE. Yes. Thank you. I absolutely agree with Dr. Paul that the Federal Reserve needs to be transparent and it needs to be accountable. I would argue that at this point, we are quite transparent and accountable. On monetary policy, besides our statement, besides our testimonies, we issue minutes after 3 weeks, we have quarterly projections, I give a press conference 4 times a year. There is quite a bit of information provided to help Congress evaluate monetary policy, as well as the public. Also, very importantly, the Federal Reserve's balance sheet, its finances, and its operations are thoroughly vetted. We produce an annual financial statement which is audited by an independent external accounting firm. We provide quarterly updates and a weekly balance sheet. We have an independent Inspector General (IG.)

We have additional scrutiny imposed by the Dodd-Frank Act. And very importantly, and this is, I think, the crux of the matter, the U.S. Government Accountability Office, the GAO, has extensive authority, broad authority to audit essentially all aspects of the Federal Reserve. And the Federal Reserve accepts that, and is cooperative with the GAO's efforts.

There is, however, one important exception to what the GAO is allowed to audit under current law, and that specifically is monetary policy deliberations and decisions. So what the audit of the Fed bill would do would be to eliminate the exemption for monetary policy deliberations and decisions from the GAO audit. So in effect, what it would do is allow Congress, for example, to ask the GAO to audit a decision taken by the Fed about interest rates.

That is very concerning because there is a lot of evidence that an independent central bank that makes decisions based strictly on economic considerations, and not based on political pressure, will deliver lower inflation and better economic results in the longer term.

So, again, I want to agree with the basic premise that the Federal Reserve should be thoroughly transparent, and thoroughly accountable. I will work with everyone here to make sure that is the case. But I do feel it is a mistake to eliminate the exemption for monetary policy and deliberations, which would effectively, at least to some extent, create a political influence or political dampening effect on the Federal Reserve's policy decisions. Thank you, Mr. Chairman.

Chairman BACHUS. Thank you. I will note that bill did not come before the Financial Services Committee, which surprised me. Throughout your tenure as Chairman, you have warned this committee and others about the dangers of the U.S. fiscal position, the annual deficit, and the growing national debt. And now, we are facing what you call correctly a fiscal cliff next January.

I mentioned in my opening statement the need for long-term restructuring of our entitlements. And as the ranking member said, I was talking about Medicaid, Medicare, and to a lesser extent, Social Security. Would you tell us why you are concerned about the fiscal cliff, what will happen to the economy if we don't do anything to address it, and what long-term strategies Congress should be thinking about as we address these issues?

Mr. BERNANKE. Certainly. Thank you. First, I think there is very little disagreement that the U.S. fiscal situation is not sustainable. Under current law, deficits will continue to grow, interest will continue to accumulate, and ultimately we will simply not be able to pay our bills. So it is very important over the long term to make decisions collectively about tax and spending policies that will bring our fiscal situation into a more sustainable configuration.

Now that, I should add, is very much a long-run proposition. Many of the issues that affect our long-term fiscal sustainability are decades rather than months or quarters in the future. And therefore, I think—I would just suggest, if I might, that in looking at these issues, we might want to go beyond the 10-year window which is usually the basis for fiscal decisions, and at least consider implications of actions for even longer horizons.

So it is very important for fiscal stability, for financial stability, for Congress to provide a credible plan for stabilizing our long-term fiscal situation as soon as possible. That is a long run proposition, however. And the way the current law is set up, we are going to have a very, very sharp contraction in the fiscal situation, increased taxes, and cuts in spending, that are very dramatic and that occur almost simultaneously on January 1, 2013.

As I discussed in my remarks, and as the CBO has documented in some detail, if that all happens, it will, no doubt, do serious damage to the recovery, and probably will cost a significant number of jobs. It is not essential to do it that way. I think the best way to address this is to attack the long-run fiscal sustainability issue seriously and credibly, but to do it in a more gradual way that doesn't have such negative effects on the recovery. And I think both of those goals can be met simultaneously, recognizing that it is not politically easy. But I believe that is the correct broad approach for addressing our fiscal situation.

Chairman BACHUS. Thank you. The ranking member is recognized for 5 minutes for questioning.

Mr. FRANK. Mr. Chairman, you say on page 6 that we should address the fiscal challenges in a way that takes into account both the need for long-range sustainability and the fragility of the recovery. There are some in the Congress who have been arguing that it is very important in the appropriations we are now voting on for the fiscal year that begins in a couple of months that we substantially reduce what we are committed to spend. Is that what you are warning us against when you talk about the fragility of the recovery? Is it the timing issue, that we should not be trying to do this in the immediate next fiscal year, but put into place a longer-term situation?

Mr. BERNANKE. I am talking about the collective impact of the tax increases and the spending cuts, which together come something close to 5 percent of GDP, which would, if it all hit at the same time, be very negative for growth. It is important to combine a more gradual approach with, of course, a longer-term plan to address sustainability.

Mr. FRANK. Let me ask you, you have been doing a great deal with your colleagues to try to provide an impetus to economic growth, at least an offset to the headwinds I think would be the way to put it. A number of people from the beginning of your efforts to do this, quantitative easing and the twist and all the other ways that you have been trying to make more money available, have warned that you were risking inflation, and some have said that this might worsen our fiscal condition because you might be losing money. You are aware of the criticisms. This many, I don't know, a couple of years into this, what is the record? Were you wrong?

Mr. BERNANKE. No, we are not wrong. I have a collection of opeds and editorials from 2008 and 2009 about immediate hyperinflation which is right around the corner, collapse of the dollar, those sorts of things. None of that has happened. None of that is

Sheila C. Bair

June 30, 2014

The Honorable Scott Garrett
Chairman, Subcommittee on Capital Markets & Government Sponsored Enterprises
U.S. House of Representatives
2129 Rayburn House Office Bldg.
Washington, DC 20515

Dear Chairman Garrett,

Thank you for inviting me to meet to discuss the Systemic Risk Council's (SRC) recent letter in opposition to proposed legislation affecting the Financial Stability Oversight Council. I appreciate your willingness to consider our views.

During our meeting, you also inquired about my views on the pending Ex-Im Bank reauthorization debate and the Federal Reserve Bank of New York's reverse repo facility. Below, I have summarized my personal thoughts on these two issues. These views are solely my own and do not reflect those of the SRC or Pew.

Ex-Im Bank Reauthorization. I have not taken a position on legislation to re-authorize the Ex-Im Bank. In general, I believe the Federal government provides far too many loan guarantees and other debt subsidies, which distort credit allocation and put taxpayers at risk. In the case of the Ex-Im Bank, most of the subsidies it provides inure to the benefit of large US exporters who could easily access debt financing without the government's help. The case for helping small exporters might be stronger, but here again, particularly given Dodd-Frank restrictions on trading activity, U.S. banks have placed renewed emphasis on traditional lending, including to smaller businesses. Thus, I believe the committee is right to question claims that credit-worthy exporters, large or small, would have trouble securing financing without the assistance of the Ex-Im Bank. (And truly small businesses would still have the option of seeking help from the Small Business Administration.) Of course, the Ex-Im Bank's backing does reduce exporters' *costs* of credit which allows them to sell their products at lower prices overseas. However, any such incremental benefit to U.S. export sales needs to be weighed against the disadvantage such subsidies impose on other U.S. companies who are trying to compete with the foreign companies who benefit from those subsidized lower prices.

If Congress wants to strengthen the competitive position of U.S. industry, a far more promising course would be corporate tax reform.

Reverse Repo. I also share concerns about the increasing role being played by the Federal Reserve in the short-term debt markets through its new "Overnight Reverse Repurchase Facility" (Facility). This Facility was established last September by the Fed's Federal Open Market Committee (FOMC) and is operated by New York Federal Reserve Bank as part of the Fed's open market operations. The original stated purpose of the facility was to test the use of reverse repos as a way to drain liquidity from the financial system when the time comes for the Fed to raise interest rates. However, it is now being used regularly by large, institutional investors, most notably money market funds and GSEs, who have found it to be an attractive place to keep their short-term funds. Daily use of the facility has been robust, hitting a high of $242 billion at the end of the first quarter. The FOMC has rapidly raised the allotment cap for individual users of the Facility from $500 million when the pilot program was initiated to the current cap of $10 billion.

In contrast to the Fed's traditional role as "lender of last resort" this facility puts the Fed in a position akin to a borrower. The Fed sells U.S. Treasury securities from its huge stockpile to a large financial institution, its "counterparty," with an agreement to repurchase the securities the next day, with a slight amount of interest. In this way the Facility gives large, nonbank financial institutions the opportunity to invest on a daily basis in a risk free asset, albeit at a low interest rate (currently .01 to .05%).

While I applaud the Fed for its creativity and foresight in testing new mechanisms to eventually transition to a normalized interest rate environment, this facility seems to have grown beyond its original stated purpose, raising several important issues. Perhaps the most important is its impact on how risk-averse short-term investors will allocate their investment dollars given the presence of this new "super-safe" investment option. Others borrowers in the short-term debt markets - the U.S. government, commercial paper issuers, banks (both repos and deposits) – will have to compete with this facility for investment dollars and all, to varying degrees, will be viewed as higher risk than lending to the Fed. Even a relatively minor market event could encourage massive fund flows to the Fed while contributing to flows *away* from these other markets. Ironically, faced with a more acute liquidity crisis, the Fed would likely have to use its new funds to provide a lifeline to the very markets that suffered. In essence, for investors seeking safety, the Fed would become the borrower of first resort. For borrowers impacted by the resulting diversion of funding, the Fed would have to become the backstop lender.

Recently, at least two senior officials have acknowledged this risk and suggested that the Fed cap counterparty allotments to address it. [1] However, it is not clear how well such caps would hold during periods of turmoil.

Congress may also want to consider the consistency of this Facility with decisions it has made in the past to limit moral hazard and market distortions emanating from expansion of the government safety net. For instance, it took many years before Congress decided to grant the Fed the authority to pay banks interest on the reserves they deposit with it. Yet, this new facility essentially gives large non-bank financial institutions the routine ability to place money in the functional equivalent of an overnight deposit with the Fed and receive interest. In addition, Congress declined to extend the FDIC's transaction account guarantee (TAG) program, a crisis-era program which provided unlimited guarantees for non-interest bearing transaction accounts (a decision I supported). Yet, with this new Facility, large non-bank financial institutions are able to obtain explicit government backing for billions placed with the Fed, without the burdens of deposit insurance premiums and the kind of prudential supervision that applies to banks.

In concluding, let me emphasize my respect (and enthusiasm) for the Fed's creativity in testing ways to eventually normalize interest rates. Defenders of the Facility have pointed to its value in

[1] See, e.g., "Two Fed Officials Suggest Reverse Repos May Need Borrowing Limits After All," WSJ Blogs, June 11, 2014. http://blogs.wsj.com/economics/2014/06/11/two-fed-officials-suggest-reverse-repos-may-need-borrowing-limits-after-all/

addressing shortages of safe, government backed collateral and the continuing, post-crisis demand for risk-free, short-term investments. The Fed is trying to meet these needs. However, the new Facility presents important issues, and I commend you for giving them a thorough review.

Sincerely,

Sheila C. Bair

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Presidential Documents

Title 3—

The President

Executive Order 12866 of September 30, 1993

Regulatory Planning and Review

The American people deserve a regulatory system that works for them, not against them: a regulatory system that protects and improves their health, safety, environment, and well-being and improves the performance of the economy without imposing unacceptable or unreasonable costs on society; regulatory policies that recognize that the private sector and private markets are the best engine for economic growth; regulatory approaches that respect the role of State, local, and tribal governments; and regulations that are effective, consistent, sensible, and understandable. We do not have such a regulatory system today.

With this Executive order, the Federal Government begins a program to reform and make more efficient the regulatory process. The objectives of this Executive order are to enhance planning and coordination with respect to both new and existing regulations; to reaffirm the primacy of Federal agencies in the regulatory decision-making process; to restore the integrity and legitimacy of regulatory review and oversight; and to make the process more accessible and open to the public. In pursuing these objectives, the regulatory process shall be conducted so as to meet applicable statutory requirements and with due regard to the discretion that has been entrusted to the Federal agencies.

Accordingly, by the authority vested in me as President by the Constitution and the laws of the United States of America, it is hereby ordered as follows:

Section 1. *Statement of Regulatory Philosophy and Principles.*

(a) *The Regulatory Philosophy.* Federal agencies should promulgate only such regulations as are required by law, are necessary to interpret the law, or are made necessary by compelling public need, such as material failures of private markets to protect or improve the health and safety of the public, the environment, or the well-being of the American people. In deciding whether and how to regulate, agencies should assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating. Costs and benefits shall be understood to include both quantifiable measures (to the fullest extent that these can be usefully estimated) and qualitative measures of costs and benefits that are difficult to quantify, but nevertheless essential to consider. Further, in choosing among alternative regulatory approaches, agencies should select those approaches that maximize net benefits (including potential economic, environmental, public health and safety, and other advantages; distributive impacts; and equity), unless a statute requires another regulatory approach.

(b) *The Principles of Regulation.* To ensure that the agencies' regulatory programs are consistent with the philosophy set forth above, agencies should adhere to the following principles, to the extent permitted by law and where applicable:

(1) Each agency shall identify the problem that it intends to address (including, where applicable, the failures of private markets or public institutions that warrant new agency action) as well as assess the significance of that problem.

(2) Each agency shall examine whether existing regulations (or other law) have created, or contributed to, the problem that a new regulation is

intended to correct and whether those regulations (or other law) should be modified to achieve the intended goal of regulation more effectively.

(3) Each agency shall identify and assess available alternatives to direct regulation, including providing economic incentives to encourage the desired behavior, such as user fees or marketable permits, or providing information upon which choices can be made by the public.

(4) In setting regulatory priorities, each agency shall consider, to the extent reasonable, the degree and nature of the risks posed by various substances or activities within its jurisdiction.

(5) When an agency determines that a regulation is the best available method of achieving the regulatory objective, it shall design its regulations in the most cost-effective manner to achieve the regulatory objective. In doing so, each agency shall consider incentives for innovation, consistency, predictability, the costs of enforcement and compliance (to the government, regulated entities, and the public), flexibility, distributive impacts, and equity.

(6) Each agency shall assess both the costs and the benefits of the intended regulation and, recognizing that some costs and benefits are difficult to quantify, propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs.

(7) Each agency shall base its decisions on the best reasonably obtainable scientific, technical, economic, and other information concerning the need for, and consequences of, the intended regulation.

(8) Each agency shall identify and assess alternative forms of regulation and shall, to the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt.

(9) Wherever feasible, agencies shall seek views of appropriate State, local, and tribal officials before imposing regulatory requirements that might significantly or uniquely affect those governmental entities. Each agency shall assess the effects of Federal regulations on State, local, and tribal governments, including specifically the availability of resources to carry out those mandates, and seek to minimize those burdens that uniquely or significantly affect such governmental entities, consistent with achieving regulatory objectives. In addition, as appropriate, agencies shall seek to harmonize Federal regulatory actions with related State, local, and tribal regulatory and other governmental functions.

(10) Each agency shall avoid regulations that are inconsistent, incompatible, or duplicative with its other regulations or those of other Federal agencies.

(11) Each agency shall tailor its regulations to impose the least burden on society, including individuals, businesses of differing sizes, and other entities (including small communities and governmental entities), consistent with obtaining the regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations.

(12) Each agency shall draft its regulations to be simple and easy to understand, with the goal of minimizing the potential for uncertainty and litigation arising from such uncertainty.

Sec. 2. *Organization.* An efficient regulatory planning and review process is vital to ensure that the Federal Government's regulatory system best serves the American people.

(a) *The Agencies.* Because Federal agencies are the repositories of significant substantive expertise and experience, they are responsible for developing regulations and assuring that the regulations are consistent with applicable law, the President's priorities, and the principles set forth in this Executive order.

(b) *The Office of Management and Budget.* Coordinated review of agency rulemaking is necessary to ensure that regulations are consistent with applicable law, the President's priorities, and the principles set forth in this Executive order, and that decisions made by one agency do not conflict with the policies or actions taken or planned by another agency. The Office of Management and Budget (OMB) shall carry out that review function. Within OMB, the Office of Information and Regulatory Affairs (OIRA) is the repository of expertise concerning regulatory issues, including methodologies and procedures that affect more than one agency, this Executive order, and the President's regulatory policies. To the extent permitted by law, OMB shall provide guidance to agencies and assist the President, the Vice President, and other regulatory policy advisors to the President in regulatory planning and shall be the entity that reviews individual regulations, as provided by this Executive order.

(c) *The Vice President.* The Vice President is the principal advisor to the President on, and shall coordinate the development and presentation of recommendations concerning, regulatory policy, planning, and review, as set forth in this Executive order. In fulfilling their responsibilities under this Executive order, the President and the Vice President shall be assisted by the regulatory policy advisors within the Executive Office of the President and by such agency officials and personnel as the President and the Vice President may, from time to time, consult.

Sec. 3. *Definitions.* For purposes of this Executive order: (a) "Advisors" refers to such regulatory policy advisors to the President as the President and Vice President may from time to time consult, including, among others: (1) the Director of OMB; (2) the Chair (or another member) of the Council of Economic Advisers; (3) the Assistant to the President for Economic Policy; (4) the Assistant to the President for Domestic Policy; (5) the Assistant to the President for National Security Affairs; (6) the Assistant to the President for Science and Technology; (7) the Assistant to the President for Intergovernmental Affairs; (8) the Assistant to the President and Staff Secretary; (9) the Assistant to the President and Chief of Staff to the Vice President; (10) the Assistant to the President and Counsel to the President; (11) the Deputy Assistant to the President and Director of the White House Office on Environmental Policy; and (12) the Administrator of OIRA, who also shall coordinate communications relating to this Executive order among the agencies, OMB, the other Advisors, and the Office of the Vice President.

(b) "Agency," unless otherwise indicated, means any authority of the United States that is an "agency" under 44 U.S.C. 3502(1), other than those considered to be independent regulatory agencies, as defined in 44 U.S.C. 3502(10).

(c) "Director" means the Director of OMB.

(d) "Regulation" or "rule" means an agency statement of general applicability and future effect, which the agency intends to have the force and effect of law, that is designed to implement, interpret, or prescribe law or policy or to describe the procedure or practice requirements of an agency. It does not, however, include:

(1) Regulations or rules issued in accordance with the formal rulemaking provisions of 5 U.S.C. 556, 557;

(2) Regulations or rules that pertain to a military or foreign affairs function of the United States, other than procurement regulations and regulations involving the import or export of non-defense articles and services;

(3) Regulations or rules that are limited to agency organization, management, or personnel matters; or

(4) Any other category of regulations exempted by the Administrator of OIRA.

(e) "Regulatory action" means any substantive action by an agency (normally published in the **Federal Register**) that promulgates or is expected to lead to the promulgation of a final rule or regulation, including notices of inquiry, advance notices of proposed rulemaking, and notices of proposed rulemaking.

(f) "Significant regulatory action" means any regulatory action that is likely to result in a rule that may:

(1) Have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;

(2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;

(3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; or

(4) Raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in this Executive order.

Sec. 4. *Planning Mechanism.* In order to have an effective regulatory program, to provide for coordination of regulations, to maximize consultation and the resolution of potential conflicts at an early stage, to involve the public and its State, local, and tribal officials in regulatory planning, and to ensure that new or revised regulations promote the President's priorities and the principles set forth in this Executive order, these procedures shall be followed, to the extent permitted by law:

(a) *Agencies' Policy Meeting.* Early in each year's planning cycle, the Vice President shall convene a meeting of the Advisors and the heads of agencies to seek a common understanding of priorities and to coordinate regulatory efforts to be accomplished in the upcoming year.

(b) *Unified Regulatory Agenda.* For purposes of this subsection, the term "agency" or "agencies" shall also include those considered to be independent regulatory agencies, as defined in 44 U.S.C. 3502(10). Each agency shall prepare an agenda of all regulations under development or review, at a time and in a manner specified by the Administrator of OIRA. The description of each regulatory action shall contain, at a minimum, a regulation identifier number, a brief summary of the action, the legal authority for the action, any legal deadline for the action, and the name and telephone number of a knowledgeable agency official. Agencies may incorporate the information required under 5 U.S.C. 602 and 41 U.S.C. 402 into these agendas.

(c) *The Regulatory Plan.* For purposes of this subsection, the term "agency" or "agencies" shall also include those considered to be independent regulatory agencies, as defined in 44 U.S.C. 3502(10). (1) As part of the Unified Regulatory Agenda, beginning in 1994, each agency shall prepare a Regulatory Plan (Plan) of the most important significant regulatory actions that the agency reasonably expects to issue in proposed or final form in that fiscal year or thereafter. The Plan shall be approved personally by the agency head and shall contain at a minimum:

(A) A statement of the agency's regulatory objectives and priorities and how they relate to the President's priorities;

(B) A summary of each planned significant regulatory action including, to the extent possible, alternatives to be considered and preliminary estimates of the anticipated costs and benefits;

(C) A summary of the legal basis for each such action, including whether any aspect of the action is required by statute or court order;

(D) A statement of the need for each such action and, if applicable, how the action will reduce risks to public health, safety, or the environment, as well as how the magnitude of the risk addressed by the action relates to other risks within the jurisdiction of the agency;

(E) The agency's schedule for action, including a statement of any applicable statutory or judicial deadlines; and

(F) The name, address, and telephone number of a person the public may contact for additional information about the planned regulatory action.

(2) Each agency shall forward its Plan to OIRA by June 1st of each year.

(3) Within 10 calendar days after OIRA has received an agency's Plan, OIRA shall circulate it to other affected agencies, the Advisors, and the Vice President.

(4) An agency head who believes that a planned regulatory action of another agency may conflict with its own policy or action taken or planned shall promptly notify, in writing, the Administrator of OIRA, who shall forward that communication to the issuing agency, the Advisors, and the Vice President.

(5) If the Administrator of OIRA believes that a planned regulatory action of an agency may be inconsistent with the President's priorities or the principles set forth in this Executive order or may be in conflict with any policy or action taken or planned by another agency, the Administrator of OIRA shall promptly notify, in writing, the affected agencies, the Advisors, and the Vice President.

(6) The Vice President, with the Advisors' assistance, may consult with the heads of agencies with respect to their Plans and, in appropriate instances, request further consideration or inter-agency coordination.

(7) The Plans developed by the issuing agency shall be published annually in the October publication of the Unified Regulatory Agenda. This publication shall be made available to the Congress; State, local, and tribal governments; and the public. Any views on any aspect of any agency Plan, including whether any planned regulatory action might conflict with any other planned or existing regulation, impose any unintended consequences on the public, or confer any unclaimed benefits on the public, should be directed to the issuing agency, with a copy to OIRA.

(d) *Regulatory Working Group.* Within 30 days of the date of this Executive order, the Administrator of OIRA shall convene a Regulatory Working Group ("Working Group"), which shall consist of representatives of the heads of each agency that the Administrator determines to have significant domestic regulatory responsibility, the Advisors, and the Vice President. The Administrator of OIRA shall chair the Working Group and shall periodically advise the Vice President on the activities of the Working Group. The Working Group shall serve as a forum to assist agencies in identifying and analyzing important regulatory issues (including, among others (1) the development of innovative regulatory techniques, (2) the methods, efficacy, and utility of comparative risk assessment in regulatory decision-making, and (3) the development of short forms and other streamlined regulatory approaches for small businesses and other entities). The Working Group shall meet at least quarterly and may meet as a whole or in subgroups of agencies with an interest in particular issues or subject areas. To inform its discussions, the Working Group may commission analytical studies and reports by OIRA, the Administrative Conference of the United States, or any other agency.

(e) *Conferences.* The Administrator of OIRA shall meet quarterly with representatives of State, local, and tribal governments to identify both existing and proposed regulations that may uniquely or significantly affect those governmental entities. The Administrator of OIRA shall also convene, from time to time, conferences with representatives of businesses, nongovernmental organizations, and the public to discuss regulatory issues of common concern.

Sec. 5. *Existing Regulations.* In order to reduce the regulatory burden on the American people, their families, their communities, their State, local, and tribal governments, and their industries; to determine whether regulations promulgated by the executive branch of the Federal Government have become unjustified or unnecessary as a result of changed circumstances; to confirm that regulations are both compatible with each other and not duplicative or inappropriately burdensome in the aggregate; to ensure that all regulations are consistent with the President's priorities and the principles set forth in this Executive order, within applicable law; and to otherwise improve the effectiveness of existing regulations: (a) Within 90 days of the date of this Executive order, each agency shall submit to OIRA a program, consistent with its resources and regulatory priorities, under which the agency will periodically review its existing significant regulations to determine whether any such regulations should be modified or eliminated so as to make the agency's regulatory program more effective in achieving the regulatory objectives, less burdensome, or in greater alignment with the President's priorities and the principles set forth in this Executive order. Any significant regulations selected for review shall be included in the agency's annual Plan. The agency shall also identify any legislative mandates that require the agency to promulgate or continue to impose regulations that the agency believes are unnecessary or outdated by reason of changed circumstances.

(b) The Administrator of OIRA shall work with the Regulatory Working Group and other interested entities to pursue the objectives of this section. State, local, and tribal governments are specifically encouraged to assist in the identification of regulations that impose significant or unique burdens on those governmental entities and that appear to have outlived their justification or be otherwise inconsistent with the public interest.

(c) The Vice President, in consultation with the Advisors, may identify for review by the appropriate agency or agencies other existing regulations of an agency or groups of regulations of more than one agency that affect a particular group, industry, or sector of the economy, or may identify legislative mandates that may be appropriate for reconsideration by the Congress.

Sec. 6. *Centralized Review of Regulations.* The guidelines set forth below shall apply to all regulatory actions, for both new and existing regulations, by agencies other than those agencies specifically exempted by the Administrator of OIRA:

(a) *Agency Responsibilities.* (1) Each agency shall (consistent with its own rules, regulations, or procedures) provide the public with meaningful participation in the regulatory process. In particular, before issuing a notice of proposed rulemaking, each agency should, where appropriate, seek the involvement of those who are intended to benefit from and those expected to be burdened by any regulation (including, specifically, State, local, and tribal officials). In addition, each agency should afford the public a meaningful opportunity to comment on any proposed regulation, which in most cases should include a comment period of not less than 60 days. Each agency also is directed to explore and, where appropriate, use consensual mechanisms for developing regulations, including negotiated rulemaking.

(2) Within 60 days of the date of this Executive order, each agency head shall designate a Regulatory Policy Officer who shall report to the agency head. The Regulatory Policy Officer shall be involved at each stage of the regulatory process to foster the development of effective, innovative, and least burdensome regulations and to further the principles set forth in this Executive order.

(3) In addition to adhering to its own rules and procedures and to the requirements of the Administrative Procedure Act, the Regulatory Flexibility Act, the Paperwork Reduction Act, and other applicable law, each agency shall develop its regulatory actions in a timely fashion and adhere to the following procedures with respect to a regulatory action:

(A) Each agency shall provide OIRA, at such times and in the manner specified by the Administrator of OIRA, with a list of its planned regulatory actions, indicating those which the agency believes are significant regulatory actions within the meaning of this Executive order. Absent a material change in the development of the planned regulatory action, those not designated as significant will not be subject to review under this section unless, within 10 working days of receipt of the list, the Administrator of OIRA notifies the agency that OIRA has determined that a planned regulation is a significant regulatory action within the meaning of this Executive order. The Administrator of OIRA may waive review of any planned regulatory action designated by the agency as significant, in which case the agency need not further comply with subsection (a)(3)(B) or subsection (a)(3)(C) of this section.

(B) For each matter identified as, or determined by the Administrator of OIRA to be, a significant regulatory action, the issuing agency shall provide to OIRA:

(i) The text of the draft regulatory action, together with a reasonably detailed description of the need for the regulatory action and an explanation of how the regulatory action will meet that need; and

(ii) An assessment of the potential costs and benefits of the regulatory action, including an explanation of the manner in which the regulatory action is consistent with a statutory mandate and, to the extent permitted by law, promotes the President's priorities and avoids undue interference with State, local, and tribal governments in the exercise of their governmental functions.

(C) For those matters identified as, or determined by the Administrator of OIRA to be, a significant regulatory action within the scope of section 3(f)(1), the agency shall also provide to OIRA the following additional information developed as part of the agency's decision-making process (unless prohibited by law):

(i) An assessment, including the underlying analysis, of benefits anticipated from the regulatory action (such as, but not limited to, the promotion of the efficient functioning of the economy and private markets, the enhancement of health and safety, the protection of the natural environment, and the elimination or reduction of discrimination or bias) together with, to the extent feasible, a quantification of those benefits;

(ii) An assessment, including the underlying analysis, of costs anticipated from the regulatory action (such as, but not limited to, the direct cost both to the government in administering the regulation and to businesses and others in complying with the regulation, and any adverse effects on the efficient functioning of the economy, private markets (including productivity, employment, and competitiveness), health, safety, and the natural environment), together with, to the extent feasible, a quantification of those costs; and

(iii) An assessment, including the underlying analysis, of costs and benefits of potentially effective and reasonably feasible alternatives to the planned regulation, identified by the agencies or the public (including improving the current regulation and reasonably viable nonregulatory actions), and an explanation why the planned regulatory action is preferable to the identified potential alternatives.

(D) In emergency situations or when an agency is obligated by law to act more quickly than normal review procedures allow, the agency shall notify OIRA as soon as possible and, to the extent practicable, comply with subsections (a)(3)(B) and (C) of this section. For those regulatory actions that are governed by a statutory or court-imposed deadline, the agency shall, to the extent practicable, schedule rulemaking proceedings so as to permit sufficient time for OIRA to conduct its review, as set forth below in subsection (b)(2) through (4) of this section.

(E) After the regulatory action has been published in the **Federal Register** or otherwise issued to the public, the agency shall:

(i) Make available to the public the information set forth in subsections (a)(3)(B) and (C);

(ii) Identify for the public, in a complete, clear, and simple manner, the substantive changes between the draft submitted to OIRA for review and the action subsequently announced; and

(iii) Identify for the public those changes in the regulatory action that were made at the suggestion or recommendation of OIRA.

(F) All information provided to the public by the agency shall be in plain, understandable language.

(b) *OIRA Responsibilities.* The Administrator of OIRA shall provide meaningful guidance and oversight so that each agency's regulatory actions are consistent with applicable law, the President's priorities, and the principles set forth in this Executive order and do not conflict with the policies or actions of another agency. OIRA shall, to the extent permitted by law, adhere to the following guidelines:

(1) OIRA may review only actions identified by the agency or by OIRA as significant regulatory actions under subsection (a)(3)(A) of this section.

(2) OIRA shall waive review or notify the agency in writing of the results of its review within the following time periods:

(A) For any notices of inquiry, advance notices of proposed rulemaking, or other preliminary regulatory actions prior to a Notice of Proposed Rulemaking, within 10 working days after the date of submission of the draft action to OIRA;

(B) For all other regulatory actions, within 90 calendar days after the date of submission of the information set forth in subsections (a)(3)(B) and (C) of this section, unless OIRA has previously reviewed this information and, since that review, there has been no material change in the facts and circumstances upon which the regulatory action is based, in which case, OIRA shall complete its review within 45 days; and

(C) The review process may be extended (1) once by no more than 30 calendar days upon the written approval of the Director and (2) at the request of the agency head.

(3) For each regulatory action that the Administrator of OIRA returns to an agency for further consideration of some or all of its provisions, the Administrator of OIRA shall provide the issuing agency a written explanation for such return, setting forth the pertinent provision of this Executive order on which OIRA is relying. If the agency head disagrees with some or all of the bases for the return, the agency head shall so inform the Administrator of OIRA in writing.

(4) Except as otherwise provided by law or required by a Court, in order to ensure greater openness, accessibility, and accountability in the regulatory review process, OIRA shall be governed by the following disclosure requirements:

(A) Only the Administrator of OIRA (or a particular designee) shall receive oral communications initiated by persons not employed by the executive branch of the Federal Government regarding the substance of a regulatory action under OIRA review;

(B) All substantive communications between OIRA personnel and persons not employed by the executive branch of the Federal Government regarding a regulatory action under review shall be governed by the following guidelines: (i) A representative from the issuing agency shall be invited to any meeting between OIRA personnel and such person(s);

(ii) OIRA shall forward to the issuing agency, within 10 working days of receipt of the communication(s), all written communications, regardless of format, between OIRA personnel and any person who is not employed by the executive branch of the Federal Government, and the dates and names of individuals involved in all substantive oral communications (including meetings to which an agency representative was invited, but did not attend, and telephone conversations between OIRA personnel and any such persons); and

(iii) OIRA shall publicly disclose relevant information about such communication(s), as set forth below in subsection (b)(4)(C) of this section.

(C) OIRA shall maintain a publicly available log that shall contain, at a minimum, the following information pertinent to regulatory actions under review:

(i) The status of all regulatory actions, including if (and if so, when and by whom) Vice Presidential and Presidential consideration was requested;

(ii) A notation of all written communications forwarded to an issuing agency under subsection (b)(4)(B)(ii) of this section; and

(iii) The dates and names of individuals involved in all substantive oral communications, including meetings and telephone conversations, between OIRA personnel and any person not employed by the executive branch of the Federal Government, and the subject matter discussed during such communications.

(D) After the regulatory action has been published in the **Federal Register** or otherwise issued to the public, or after the agency has announced its decision not to publish or issue the regulatory action, OIRA shall make available to the public all documents exchanged between OIRA and the agency during the review by OIRA under this section.

(5) All information provided to the public by OIRA shall be in plain, understandable language.

Sec. 7. *Resolution of Conflicts.* To the extent permitted by law, disagreements or conflicts between or among agency heads or between OMB and any agency that cannot be resolved by the Administrator of OIRA shall be resolved by the President, or by the Vice President acting at the request of the President, with the relevant agency head (and, as appropriate, other interested government officials). Vice Presidential and Presidential consideration of such disagreements may be initiated only by the Director, by the head of the issuing agency, or by the head of an agency that has a significant interest in the regulatory action at issue. Such review will not be undertaken at the request of other persons, entities, or their agents.

Resolution of such conflicts shall be informed by recommendations developed by the Vice President, after consultation with the Advisors (and other executive branch officials or personnel whose responsibilities to the President include the subject matter at issue). The development of these recommendations shall be concluded within 60 days after review has been requested.

During the Vice Presidential and Presidential review period, communications with any person not employed by the Federal Government relating to the substance of the regulatory action under review and directed to the Advisors or their staffs or to the staff of the Vice President shall be in writing and shall be forwarded by the recipient to the affected agency(ies) for inclusion in the public docket(s). When the communication is not in writing, such Advisors or staff members shall inform the outside party that the matter is under review and that any comments should be submitted in writing.

At the end of this review process, the President, or the Vice President acting at the request of the President, shall notify the affected agency and the Administrator of OIRA of the President's decision with respect to the matter.

Sec. 8. *Publication.* Except to the extent required by law, an agency shall not publish in the **Federal Register** or otherwise issue to the public any regulatory action that is subject to review under section 6 of this Executive order until (1) the Administrator of OIRA notifies the agency that OIRA has waived its review of the action or has completed its review without any requests for further consideration, or (2) the applicable time period in section 6(b)(2) expires without OIRA having notified the agency that it is returning the regulatory action for further consideration under section 6(b)(3), whichever occurs first. If the terms of the preceding sentence have not been satisfied and an agency wants to publish or otherwise issue a regulatory action, the head of that agency may request Presidential consideration through the Vice President, as provided under section 7 of this order. Upon receipt of this request, the Vice President shall notify OIRA and the Advisors. The guidelines and time period set forth in section 7 shall apply to the publication of regulatory actions for which Presidential consideration has been sought.

Sec. 9. *Agency Authority.* Nothing in this order shall be construed as displacing the agencies' authority or responsibilities, as authorized by law.

Sec. 10. *Judicial Review.* Nothing in this Executive order shall affect any otherwise available judicial review of agency action. This Executive order is intended only to improve the internal management of the Federal Government and does not create any right or benefit, substantive or procedural, enforceable at law or equity by a party against the United States, its agencies or instrumentalities, its officers or employees, or any other person.

Sec. 11. *Revocations.* Executive Orders Nos. 12291 and 12498; all amendments to those Executive orders; all guidelines issued under those orders; and any exemptions from those orders heretofore granted for any category of rule are revoked.

William J. Clinton

THE WHITE HOUSE,
September 30, 1993.

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