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Statement by

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of the

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I appreciate this opportunity to testify in connection with two pieces of legislation currently before Congress--the Zero-Inflation Resolution and H.R. 2795, the Federal Reserve Reform Act of 1989. Each of these, in its own way, raises issues that go to the heart of monetary policymaking in this country. The resolution would clarify congressional intent as to the broad objectives of policy, while H.R. 2795 would make changes in the structure and day-to-day practices of the Federal Reserve.

The possible implications of the proposed legislation should be given careful consideration. As our central bank, the Federal Reserve has been entrusted with a number of responsibilities deemed essential to the effective functioning of our economy, including upholding the purchasing power of the nation's currency, facilitating the smooth operation of payment systems, and standing ready as the lender of last resort. These responsibilities and the structure of the Federal Reserve have evolved from many years of deliberation about the proper role of a central bank in a democratic society. The question is how such a society can best construct a central bank that combines public accountability with the authority necessary to perform effectively.

The answer in the case of the United States has been the complex structure of the Federal Reserve System, which includes special qualities germane to the

institution's charge. The System as a whole, including the 12 Reserve Banks, was established as a balancing of diverse regional and economic interests. By including representatives of the Reserve Banks on the primary decisionmaking body of our central bank, Congress and the President signalled the importance of those regional perspectives and helped ensure that monetary policy would reflect the needs of the entire nation. The Federal Reserve also has been deliberately accorded a significant degree of insulation from day-to-day political pressures: for example, the members of the Board of Governors are appointed to 14-year terms and our budgets are not subject to oversight by the Administration or, more generally, to the authorization and appropriation process. While we have been given broad guidelines for policy and report regularly on our plans to carry them out, the near-term conduct of policy has been explicitly distanced from the political arena. This insulation has not meant isolation, as we coordinate and consult extensively with both the executive and legislative branches.

The System has been given an element of independence within government because the effective implementation of its special functions has been perceived to require it. This independence enables the central bank to resist short-term inflationary biases that might be inherent in some aspects of the political process. The

Federal Reserve must take actions that, while sometimes unpopular in the short run, are in the long-run best interests of the country. The standard of living of the American people will be higher over time if we pursue monetary policies that are consistent with long-term price stability. Deviating from the path of policies directed toward long-term stability can create a temporary surge in an economy, but only at a longer-term cost in terms of unemployment and lowered standards of living that far exceeds the short-term benefits of revving up an economy.

The structure of the Federal Reserve, as well as its relationship with other parts of government, has evolved over time as Congress and the Executive have sought to define the appropriate role and powers to grant a U.S. central bank. The considerable debate and study that went into the establishment of the Federal Reserve did not prevent the government from making major changes in the central bank's structure as, over time, the need for those changes was clearly demonstrated. In particular, a mid-course correction was undertaken in the 1930s. Further, less striking refinements have occurred in the intervening years.

The Federal Reserve as it stands today is the result of many years of informed discussion and refinement; that need not imply that its structure is the best of all possible structures. But it is one that works. It is a

system in which the various parts mesh, and the job gets done. Changing such an organization, even perhaps improving one or more parts of it, may well have unforeseen and unfortunate consequences elsewhere in the structure. In other words, change, while it may have benefits, also has potential costs. The fact that the existing Federal Reserve institutional structure has been unchanged for many years has enabled the organization to develop a means of operation dedicated to the most efficient carrying out of our responsibilities. Where elements of the structure have been less than optimum, relationships have evolved to compensate. If the structure is altered, time will be required to re-compensate. In short, for a period of time the efficacy of the organizational structure will decline.

H.J. Res. 409

The Zero-Inflation Resolution represents a constructive effort to provide congressional guidance to the Federal Reserve. If passed, it would further clarify the intent of Congress and the President as expressed in prior legislation. Legislative direction as to the appropriate goals for macroeconomic policy in general and monetary policy in particular have been provided before.

Unfortunately, the instructions have defined multiple objectives for policy, which have not always been entirely consistent--at least over the near term.

The current resolution is laudable, in part because it directs monetary policy toward a single goal, price stability, that monetary policy is uniquely suited to pursue. While such influences as oil price shocks, droughts, depreciation of the dollar, or excise tax hikes may boost broad price indexes at one time or another, sustained inflation requires at least the acquiescence of the central bank.

Moreover, the objective set in this legislative proposal would promote the welfare of the American people, because price stability is a prerequisite for, over time, maximizing economic growth and standards of living. As the resolution spells out, the elimination of inflation would allow the economy to operate more efficiently and productively by reducing the need to predict and to protect against inflation. The elimination of inflation would allow interest rates to decline and would reduce the uncertainty about price trends that can discourage saving and investment. In general, as I indicated earlier, over the long run, price stability is a precondition to the economy turning in its best possible performance. It is for this reason that the Federal Reserve remains determined to reach this goal.

The resolution explicitly recognizes this long-run relationship, and in an effort to get there, it sets a five-year deadline on eliminating inflation. Such a deadline is

attainable, but it would have costs. During this transition period, growth could be reduced for a while from what it otherwise would have been. Because price-setting behavior in our economy has considerable momentum, the requisite slowing of demand would tend to translate, in the first instance, into a slowing of real output and only subsequently into restraint on prices. In the longer run, of course, whatever losses are incurred in the pursuit of price stability would surely be more than made up in increased output thereafter.

The extent of the near-term slowdown in real output would be influenced by a variety of factors, including importantly the strength of inflation expectations. At the moment, after seven years of inflation trending around a 4 percent annual rate, individuals, businesses, and financial markets appear to believe with some conviction that inflation is likely to remain in this vicinity. Of course, over the years, monetary policy will be bringing inflation down further, and inflation expectations will adjust downward as well, but the mere passage of legislation such as this could be helpful in reducing those expectations even more quickly. Nevertheless, with the nation's last prolonged period of approximately stable prices now a generation in the past, the public is likely to remain skeptical until it observes real, consistent progress.

The elimination of inflation is not a simple mechanical operation. To minimize the costs associated with the process and to react to unexpected events, the Federal Reserve must retain significant flexibility. Monetary policy is only one of many influences on the economy. The stance of fiscal policy, the condition of financial markets, and the course of foreign economic developments are among the other major factors affecting the economy. As events unfold, adequate policy responsiveness requires ongoing judgment and flexibility in decisionmaking by the monetary authorities.

Various other influences on the economy can prove either helpful or harmful in the process of eliminating inflation. For example, maintaining free and open markets for products and productive resources is a key factor in facilitating that process. Competitive markets provide the most efficient and complete employment of resources, allowing the economy to grow at its potential. The flexibility provided by free markets is especially beneficial during periods of transition, such as that implied by this resolution. Thus, reducing unnecessary regulations and rigidities could, by enhancing market flexibility, lessen the strain of adapting to a stable-price environment. This conclusion applies with respect both to domestic impediments and to international barriers; protectionism can raise the costs of lowering inflation.

The federal deficit also would affect the path to price stability. To the extent that the federal government restrains its demand, the need for restraining private sector credit demand would be reduced and funds would become more available for that sector. In other words, the degree of monetary policy restraint implicitly mandated by the resolution's five-year deadline would be lessened by better balance in the federal government's accounts.

The Federal Reserve Board fully supports the thrust of the current resolution, because price stability is in the best interests of the nation, and because it is achievable. But the reminder that significant costs could accompany the transition to stable prices is also a reminder, both to the Federal Reserve and to the rest of the government, that efforts would have to be made to minimize those costs. By minimizing the transition costs, we ensure the continued willingness to pay those costs so that we may realize the long-term, and very substantial, benefits of price stability.

H.R. 2795: Secretary of the Treasury

In the remainder of my testimony, I will take up each of the provisions of the second piece of legislation under consideration, H.R. 2795, in the order it presents them. The first provision would make the Secretary of the Treasury a member of the FOMC. I understand, however, that

this provision is being changed instead to require periodic meetings between the FOMC and representatives of the Administration.

I was pleased to hear that the original provision would disappear, because expanding the Secretary's responsibilities in that manner could have significant, adverse effects on monetary policy. As you know, legislation in 1935 explicitly removed the Secretary from the Federal Reserve Board, and the clear intent of Congress in doing so was to assure that the Federal Reserve would be insulated from day-to-day political pressure and influence by the Treasury Department and the Administration. Placing the Secretary of the Treasury on the FOMC would have torn away an essential part of that insulation. Moreover, as the Administration official responsible for funding the federal government, the Secretary might face conflicting goals--on the one hand, the immediate need to finance the deficit at the lowest possible interest rates, and, on the other, the obligation to support a monetary policy consistent with a stable economic environment over time.

The substitute provision replaces that more radical change with the requirement to hold several meetings each year. I am fully in favor of productive exchanges of information and opinions between members of the FOMC and members of the Administration. In fact, there already exist a large number of forums in which those views are aired,

providing ample opportunity for the Administration to make us aware of its perspective. We maintain a close working relationship with the Secretary and the Treasury generally, as well as with other departments and agencies, including the Office of Management and Budget. Board and Treasury staffs are in daily communication with each other, and the Secretary and I meet at least once a week. I also meet often with the Chairman of the Council of Economic Advisers, and I speak frequently by telephone with both the Chairman and the Secretary.

As a consequence of these contacts, both the Administration and the Federal Reserve are fully informed about each other's views on the economy and their plans for policy. These interactions contribute to the coordination that is so necessary in carrying out the nation's economic policy. Moreover, to ensure the continued coordination of macroeconomic policy, the Full Employment and Balanced Growth Act of 1978 already requires us, in our semiannual reports to Congress, to relate our objectives to the economic goals set forth by the Administration.

Notwithstanding the existing channels, I would support expanding these contacts if the individuals involved feel it would be useful. Specifically, more frequent meetings of the so-called Quadriad--the Secretary of the Treasury, the Chairman of the Council of Economic Advisers, the Director of Management and Budget, and the Chairman of

the Federal Reserve Board, with or without the President-- might be useful. What I do not favor is the creation of unnecessary and duplicative arrangements, which would set up highly formalized channels of communication, such as those apparently called for in the substitute provision.

Under this proposal, the required meetings, involving the FOMC and the Quadriad, would take place immediately before certain, key FOMC meetings. Although intended only to improve the coordination of economic policymaking, the proposal, by subjecting the FOMC to a more intensely political perspective, could risk bending monetary policy away from long-term strategic goals.

The ability of the Federal Reserve to conduct monetary policy as it does today--with relative freedom from day-to-day pressures from the Administration, as provided by Congress itself--has served the nation well over the years and should be retained.

H.R. 2795: Coterminus Term

The satisfactory performance of the status quo also enters into the debate surrounding other provisions of the bill. One section would alter the schedule on which the Chairman of the Board of Governors is appointed. While generally maintaining the current, four-year length of that term, it would make it begin one year after the beginning of a presidential term, thereby always allowing a new President to appoint a new Chairman about a year after inauguration.

Should the Chairmanship become vacant prematurely, an appointment could be made only for the remainder of the unexpired term. By contrast, the present system has an element of chance: all Chairmen are appointed to four-year terms, and because some did not serve out their full terms, the relation of the Chairman's term to that of the President has changed over the years.

Proposals to change to coterminus, or approximately coterminus, terms have been discussed and debated for more than 25 years. The main reason advanced for making the change has been to promote better coordination of macroeconomic policy between the Administration and the Federal Reserve. The prompt appointment of a compatible Chairman would help ensure that monetary policy complements the Administration's policy stance, and it would reduce the potential for prolonged policy conflicts. In addition, there has been some concern that current law could result in the Chairman's appointment regularly occurring during the very politicized atmosphere of a presidential election. On the other side of the debate, opponents have argued that the change would move too much in the direction of linking the Federal Reserve to the White House and it would run counter to the important principle of maintaining the Federal Reserve's policy at some arm's length from the Executive.

At various times over the years, the Federal Reserve has both supported and opposed proposals of this

type. Having looked at the arguments on both sides, I do not find those in favor of the change to be particularly persuasive. As I indicated earlier, ample opportunities for coordination of policy already exist. In addition, I am concerned that linking the Chairman's term to the President's would imply less independence from the White House than up to now has prevailed. Moreover, some practical problems could arise in response to the need to fill an unexpired term. For example, should the Chairmanship open up with only a relatively short time left to run, it might be very difficult to induce the best qualified person to accept the position on a short-term basis, as an intervening presidential election would prevent any assurance of reappointment.

To my mind the present arrangement has worked reasonably well. I do not perceive strong advantages in changing it.

H.R. 2795: Immediate Disclosure

Another provision of the bill would affect the daily implementation of policy by requiring the immediate disclosure of all monetary policy actions. The argument for this proposal rests on the importance of openness and accountability in our government, and on the perceived value of promptly giving markets all available information.

I agree that these are vital characteristics, and I believe that the Federal Reserve's record on this score has

been good. We make our decisions public immediately, except when doing so could undercut the efficacy of policy or compromise the integrity of policymaking. When we change the discount rate or reserve requirements, those decisions are announced at once. When we establish new ranges for money and credit growth, those ranges are set forth promptly in our reports to Congress. And when Congress requests our views, we come before this Committee and others to testify. Moreover, we publish our balance sheet every week with a one-day lag. What we do not disclose immediately are the implementing decisions with respect to our open market operations. However, even the operating targets ultimately are released to the public. We publish a lengthy record of the policy deliberations and decisions from each Federal Open Market Committee meeting shortly after the next regular meeting has taken place. In this respect, the Federal Reserve compares very favorably with the central banks of other major industrial nations.

The immediate disclosure of any changes in our operating targets would make this information available more quickly to all who were interested, but it also would have costs. Simply put, this provision would take a valuable policy instrument away from us. It would reduce our flexibility to implement decisions quietly at times to achieve a desired effect while minimizing possible financial market disruptions. Currently, we can choose to make

changes either quite publicly or more subtly, as conditions warrant. With an obligation to announce all changes as they occurred, this distinction would evaporate; all moves would be accompanied by announcement effects akin to those currently associated with discount rate changes. If markets always accurately assessed the implications of such announcements, incorporating them into the structure of prices, then market efficiency might be enhanced by making our open market objectives public immediately. However, prices can, and do, overreact to particular announcements, as the stock market movements of the last two weeks seem to confirm. The loss of flexibility implied by the announcement requirement would be regrettable, especially in view of the inevitable uncertainties surrounding the outlook for financial markets and the economy.

The need for flexibility is especially pressing in times of acute financial unrest. At those times, it is imperative that the Federal Reserve remain able to respond promptly and in whatever manner is most appropriate to the moment. The fluidity of financial crises requires the same kind of fluidity in our response. Some types of announcements could well be helpful in such circumstances-- as, for example, the very general statement made at the time of the October 1987 stock market crash appeared to be. However, it would be ill-advised and perhaps virtually impossible to announce short-run targets for reserves or

interest rates when markets were in flux. Our open market operations might depend on market conditions at the moment and might not be accurately represented by an announcement of a particular goal for reserves or interest rates. Moreover, the specific instrument settings might themselves be changing as developments unfolded. Markets are often prone to overreact at times when the financial system appears fragile, and under these conditions, the requirement to publicize each change could risk further unsettling markets.

In the normal course of events, a public-announcement requirement also could impede timely and appropriate adjustments to policy. In recent years, the Federal Reserve has been most successful when it has anticipated pressures on the economy and has moved promptly to counter them. The immediate announcement of changes to our instrument settings could adversely affect the policymaking process that has made this possible and could impart a degree of sluggishness to policy responses. The Federal Reserve might be forced to focus more on the announcement effect associated with its action, than on the ultimate economic impact.

Currently, the basic policy stance of the Federal Reserve is reviewed by Congress and the nation when we present our semiannual report on monetary policy. The longer-run ranges for money and credit, along with other

considerations set forth in those reports, constitute the framework within which shorter-run, implementing actions are taken. Should the basic policy objectives change, that would be announced promptly. The current debate concerns only the immediate disclosure of operational decisions connected with carrying out those basic objectives. Our conclusion is that mandating such announcements would yield only marginal rewards, but could significantly reduce the effectiveness of policy.

H.R. 2795: GAO Audit

A similar conclusion holds with respect to the bill's next provision, which would extend the scope of the General Accounting Office's audits of the Federal Reserve by allowing the GAO to review our monetary policy activities. The monetary policy area was one of the very few areas of Federal Reserve activity explicitly exempted from review by the Federal Banking Agency Audit Act of 1978, which authorized GAO audits of the remaining functions.

We fully appreciate the interest of Congress and the public in the conduct of monetary policy. Indeed, surveillance and disclosure of governmental activities is essential in a democratic society. It is only when certain aspects of these requirements undercut the capability of an agency to carry out its mandate from Congress that they may not be in the public interest. There is a tradeoff of values--the valid desire of the public for surveillance and

disclosure relative to the value to the public of effective policy.

The benefits proposed by H.R. 2795 would in my judgment be small because the enhanced GAO audit would tend to duplicate functions that are already performed. Specifically, the monetary policy function of the Federal Reserve is, in effect, already audited by Congress itself when we present testimony and semiannual monetary policy reports. Moreover, a vast and continuously updated literature of expert evaluations of U.S. monetary policy exists. The contribution that a GAO audit would make to the active, public discussion of the conduct of monetary policy in this country is not likely to outweigh the possible negatives.

Those negatives would include a potential compromising of Federal Reserve effectiveness, in part because the FOMC might feel heightened pressure from Congress, through this channel, to exercise other than its best professional judgment on policy matters. Even aside from the possibility that this provision might influence the stance of monetary policy, GAO scrutiny of policy deliberations, discussions, and actions could impede the process of formulating policy. A free discussion of alternative policies and possible outcomes is essential to minimize the chance of policy errors. The prospect of GAO review of formative discussions, background documents, and

preliminary conclusions could have a chilling effect on the free interchange and consensus-building that leads to good policy. Responsible review of policy results is welcome--a function already performed by Congress itself--but second-guessing of the policy process could prove detrimental to that process, and ultimately to the effectiveness of policy.

H.R. 2795: The Budget Process

At this point, I would like to turn to the final section of the bill, the section related to the budgetary treatment of the Federal Reserve. This issue of budgetary treatment is one that has been considered many times. After each review, Congress has concluded that the Federal Reserve's functional independence is inseparable from its budgetary independence. Subjecting the Federal Reserve's budget to review by the Administration and to the appropriations process could allow inappropriate political pressures to be brought to bear on the monetary authorities and on the making of monetary policy. The current proposal exhibits some sensitivity to this issue by providing that the Federal Reserve budget would be included in the budget by the President without change. In addition, as we understand it, the bill does not intend to subject the Federal Reserve to the appropriations process, although it is not explicit on this point. Nevertheless, the bill represents a potential first step toward placing both the

Federal Reserve budget and Federal Reserve policy more closely under short-run political control.

The benefits of making this change would be minor compared with the costs because substantial and detailed information on the Federal Reserve's spending and operations is already available. Budgets for both the Board of Governors and the Reserve Banks are discussed and approved in public meetings of the Board. This Committee holds annual oversight hearings at which we present testimony on these budgets, with a full airing of issues related to our revenues and expenditures. The budget of the Board is published annually as an information item in the appendix to the federal budget and the estimated net income of the System is currently included in the budget itself. In addition, since 1986 we have published a separate Budget Review supplement to our annual report; this supplement was developed explicitly to present the details of our financial stewardship in a comprehensive, yet accessible, manner. Finally, very detailed data on the Federal Reserve's spending, drawn directly from our accounting and management information system, are made available to the public on a quarterly basis.

Bringing the Federal Reserve into the budget document would not enhance the available information about our revenues and expenditures, nor would it change the way our activities affect the fiscal balance. The Federal

Reserve's large net earnings are paid over to the Treasury each year and are properly recorded as a receipt in the U.S. budget. Thus, the budget already reflects the influence of Federal Reserve operations on the overall fiscal position of the government.

Requiring the Federal Reserve to make budget submissions would translate into requiring the institution to maintain a dual accounting system. The Federal Reserve currently keeps its books according to generally accepted accounting principles, and would have to continue to do so for a variety of reasons, including the Monetary Control Act's requirement that we price our services competitively. Thus, a shift to federal budget accounting would require not merely a one-time change, but ongoing duplicate accounting. As a result, in order to provide meaningful data for the federal budget document, the Federal Reserve would have to incur several million dollars a year in additional expenses.

I certainly share the view that the Federal Reserve must be fully accountable to the American people for its spending, as well as for its policy actions. We regard it as our duty to give a complete, public accounting of our operations. But this proposal would yield very little in the way of benefits to the American people while entailing some real costs.

Integrating Federal Reserve expenditures into the federal budget, contrary to our entire history and earlier

congressional decisions, would, I fear, be interpreted as a clear step toward heightened political influence and control over the central bank.

Conclusion

In reviewing the legislation before us today, it is, broadly speaking, the appropriate degree of guidance and control over the Federal Reserve that is at issue. The Zero-Inflation resolution is an example of appropriate guidance for the central bank, if Congress chooses to go in this direction. In further clarifying the government's long-run goals for monetary policy, the resolution would provide a broad framework and direction to the Federal Reserve. While we at the Federal Reserve sympathize with the desire for openness and accountability embodied in H.R. 2795, our considered view is that the provisions of this bill move only marginally, if at all, in this direction. Moreover, the proposed changes could well prove detrimental to the implementation of effective monetary policy. In the Board's judgment--as citizens, not just as members of the Federal Reserve System--it is a poor tradeoff.

In this regard, several points warrant repeating: first, that the independence of the Federal Reserve has, in practice, served the country well; second, that Congress, in revisiting this issue on numerous occasions, has repeatedly reaffirmed that independence; and third, that while each proposal alone might represent only a small step, taken

together they would erode this independence and, with it, the Federal Reserve's ability to carry out its responsibilities.

The Federal Reserve is part of government, operating with the other arms of government to further the economic objectives of the nation. The Federal Reserve is always subject to change through the legislative process. But in making changes, I would urge you to be sure there are sufficiently compelling considerations of policy in favor of the change. Those factors must be judged to outweigh the pragmatic considerations of tampering with a structure that has proven resilient and useful, as well as the risks of impairing our long-run prospects for economic growth.

In the past, Congress has steadfastly supported the independence of the Federal Reserve. I can only encourage Congress now to reaffirm this commitment.