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Pending Fed Reform Legislation Won't Improve Economic Policy and May Actually Harm It, Brookings' Kohn testifies

Nothing seriously amiss with the Federal Reserve; independence needs to be maintained

Although "no institution is perfect," and Congress is correct to be asking tough questions about the Federal Reserve and monetary policy in the wake of the financial crisis, pending legislation to reform the Fed is unlikely to improve it and may indeed harm it, testified Brookings Senior Fellow Donald Kohn before the House Committee on Financial Services Monetary Policy and Trade Subcommittee

"In my view, the actions of the Federal Reserve in the crisis and slow recovery were necessary and appropriate. Its conduct of monetary policy has been as systematic as possible under unprecedented and constantly evolving circumstances, and it has been especially transparent about how those monetary policy actions were expected to foster achievement of its legislated mandate and what it would be looking at in the future to gauge the need for future actions," he stated.

"No institution is perfect. Circumstances change, lessons are learned, and all policy institutions must adapt if they are to continue to serve the public interest as well as possible. You are right to be asking tough questions about whether further improvements in the Federal Reserve's performance as well as your oversight and the Fed's accountability are possible, and the extent to which new legislation is needed to make those changes. In my view, however, the suggestions in the proposed legislation, as I weigh their costs and benefits, are not likely to improve the Federal Reserve's performance and enhance the public interest, and could very well harm it." Kohn laid out objections to the legislation as follows:

Policy rules and GAO audits would be useless and possibly counterproductive. The Fed is as "systematic, predictable, and transparent as possible" which increases the effectiveness of monetary policy by helping private market participants accurately anticipate Fed actions and it also enhances Congress' ability to assess the Fed's policy strategies. But there must be recognition of the limits of the Fed's knowledge: "the U.S. economy is a complex and ever-changing system that cannot be comprehensively summarized in a few variables and empirical relationships. Not only are the relationships imperfectly understood and evolving, but unexpected developments here and around the world can affect the U.S. economy….Requiring the Federal Reserve to send you a rule that includes 'a function that comprehensively models the interactive relationship between intermediate policy inputs' and 'the coefficients of the directive policy rule that generate the current policy instrument target' would be at best a useless exercise for you, the Federal Reserve, and the American public and could well prove counterproductive for achieving goals and understanding strategies.

More changes to emergency lending powers for nonbanks might make panics harder to stop. Thanks to Dodd-Frank, Congress has already made changes on lending to nonbanks and added a more reforms on reporting, collateral, and approval by the secretary of the Treasury. "I would not go further; in fact I'm concerned that some of what you [Congress] have already done might limit the effectiveness of the Federal Reserve's lender of last resort function for a 21st century financial market—make panics even harder to stop and raise the risk that households and businesses would lose access to credit…We need to keep in mind that difficult judgments are required in such a situation—especially about solvency and collateral valuations…. Central banks need to be able to make such judgment calls quickly—and explain them to the public—and they need to be sure not to add to market problems by chasing collateral values down or judging otherwise sound institutions as insolvent."

The proposed monetary commission is too political, erodes independence. "The proposal before us has a panel rooted in partisan politics, not expertise, and its make-up is strongly tilted to one side. It has in effect pre-judged one aspect of the conclusions by mandating that a reserve bank president be included, but not a member of the board of governors. Shifting authority from the Board to the presidents is a general theme of many of the proposals before us and as a citizen I find it troubling. The reserve banks and their presidents make valuable contributions to the policy process; in particular they bring a greater diversity of views than is often found on the board of governors. But they are selected by private boards of directors, to be sure with the approval of the board of governors, and giving them greater authority would in my view threaten the perceived democratic legitimacy of the Federal Reserve over time….I believe that public support for the Federal Reserve in our democratic society requires that the authority of the Board not be eroded…I urge you to keep the current balance in place," he concluded.

Read the full testimony