

Perspectives on Balance Sheet and Credit Policies:
A Tribute to Marvin Goodfriend

Remarks by

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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers, or representatives.

I appreciate this opportunity to pay tribute to Marvin Goodfriend and his many contributions to the theory and practice of monetary policy.¹ At the Kansas City Fed, we knew Marvin as a scholar and a good Federal Reserve colleague. Marvin also was a participant in a number of our Jackson Hole Economic Symposiums. As a Research Officer at the Richmond Fed, he attended the first symposium that we held in Jackson Hole, Wyoming, in 1982, where his work on “Discount Window Borrowing, Monetary Control, and the Post-October 6, 1979 Federal Reserve Operating Procedures” was widely cited.² Thirty-four years later in 2016, as a professor at Carnegie Mellon, he presented a paper making the case for deeply negative interest rates as a policy tool that could breach the zero lower bound on nominal rates. He argued that “the zero interest bound encumbrance on monetary policy should be removed so that movements in the intertemporal terms of trade can be reflected fully in interest rate policy to sustain price stability and full employment *with a minimum of inefficient and costly alternative policies* [emphasis added].”³

Willing to challenge conventional views, Marvin expressed concern that “central banks [would] be tempted to rely even more heavily on balance sheet policy in lieu of interest rate policy, in effect exerting stimulus by fiscal policy means via distortionary credit allocation, the assumption of credit risk and maturity transformation, all taking risks on behalf of taxpayers and all moving central banks ever closer to destructive inflationary finance.” He understood the associated heartburn of this view, acknowledging that negative interest rates was an idea that would likely require “some getting used to.” He noted, however, that the public also was initially

¹ I thank Kansas City Fed Vice President and Economist George Kahn for his assistance in preparing these remarks.

² Later published in the *Journal of Monetary Economics*, September 1983, pp. 343-56.

³ Marvin Goodfriend, “The Case for Unencumbering Interest Rate Policy at the Zero Lower Bound,” Federal Reserve Bank of Kansas City Economic Policy Symposium, Jackson Hole, 2016, pp. 127-160. <https://www.kansascityfed.org/~media/files/publicat/sympos/2016/2016goodfriend.pdf?la=en>

resistant to leaving the gold standard, and later to floating the exchange rate, but gradually accepted these changes.

While the use of negative interest rates gives me pause as a way to address a future encounter with the effective lower bound, I share Marvin's concerns about the potential side effects of balance sheet policies that pose risks to financial stability and threaten the central bank's policy independence.

As a voting member of the Federal Open Market Committee (FOMC) in 2013, I expressed my concerns about the continuation of the asset purchase program known popularly as QE3. By then, financial markets were stable and the economy was growing. These concerns about the expansion of the Fed's balance sheet under those conditions echoed many of Marvin's concerns. In my view, the possible unintended side effects of the ongoing asset purchases posed risks to economic and financial stability and served to unnecessarily further complicate future monetary policy.⁴ Today, however, it is conventional wisdom that the benefits of asset purchases have been clearly established and that their potential costs have proven negligible. History and further research may ultimately affirm that wisdom, but it remains less than clear to me that the longer-run costs of balance sheet policies have been fully taken into account.

As a consequence of large-scale asset purchases, for example, the FOMC had to evaluate and reconsider its longstanding operating framework. Given the abundant reserves associated with its balance sheet policies, the FOMC had to consider whether the federal funds rate target could be achieved administratively by setting the interest rate on excess reserves. Indeed, to ensure effective interest rate control and establish a firm floor on overnight rates, an overnight

⁴ Esther George, "Fed Balance Sheet 101," Remarks to the Federal Reserve Bank of Kansas City Economic Forum, Denver, Colorado, July 2017. [https://www.kansascityfed.org/~media/files/publicat/speeches/2017/2017-george-denver-07-12.pdf](https://www.kansascityfed.org/~/media/files/publicat/speeches/2017/2017-george-denver-07-12.pdf)

reverse repo facility was created. In addition, as the Fed began to shrink its balance sheet, it proved challenging to gauge the minimum reserve balances needed for achieving the federal funds rate target without intervention by the open market desk at the New York Fed. As a result, the desk resumed regularly conducting repo operations and outright purchases of Treasuries to build a bigger buffer and ensure an ample supply of reserves. These operations have caused some confusion in markets as some participants have seen them—incorrectly, in my view—as a type of quantitative easing.

More generally, to the extent that large-scale asset purchases succeeded in their aim of creating a wealth effect, they also played some role in contributing to elevated asset valuations. These effects, together with the perception that interest rates will remain at historically low levels for a prolonged period, can lead to a buildup of financial imbalances that ultimately pose risks to the real economy. Experience has shown that these imbalances can develop in sectors outside the lens of regulators and, as we witnessed a decade ago, can unwind with little warning.

Another concern I share with Marvin is the risk that income from the Fed's large balance sheet combined with our capital surplus could tempt fiscal authorities to view the Fed as a source of funding for government programs. I would argue that we have seen a degree of this risk unfold. The funding of the Consumer Financial Protection Bureau (CFPB), as required under the Dodd-Frank Act, is a case in point. Each quarter the Reserve Banks transfer to the CFPB, without Congressional appropriations, the amount of funds requested by the Director of the CFPB to carry out its operations. To date, the Federal Reserve has transferred almost \$4.4 billion to the CFPB. In addition, the Dodd-Frank Act required the Fed to fund the first two years of the Office of Financial Research in support of the Financial Stability Oversight Council (FSOC).

Yet another example of congressional funding of programs outside the regular appropriations process is the “Fixing America’s Surface Transportation (FAST) Act.” In the FAST Act, Congress funded highway construction by reducing the Federal Reserve Bank stock dividend rate for member banks with assets of more than \$10 billion. The Act also placed a cap of \$10 billion on the aggregate surplus funds of the Federal Reserve and directed that any excess be transferred to the Treasury general fund. The potential policy implications of modifying dividends to member banks, or more generally, the requirement for member banks to purchase stock in a regional Federal Reserve Bank, is a concerning development that risks undermining the Federal Reserve’s long-standing institutional design of public and private interests serving the American public.⁵

To ensure the central bank maintains surplus capital against prospective exposures on a balance sheet inflated by large scale asset purchases, Marvin argued that the central bank must have independent authority to retain its net interest earnings to build surplus capital. Without such capital, the “carry trade” exposure from the balance sheet would “[jeopardize] the operational credibility of monetary policy for price stability.”⁶

Finally, Marvin was adamant that central bank independence was essential for the credibility and effectiveness of monetary policy. In testimony before Congress, Marvin said:

“Flexibility and decisiveness are essential for effective central banking. Independence enables a central bank to react promptly to macroeconomic or financial shocks without the approval of the Treasury or legislature. Central bank initiatives must be regarded as

⁵ Esther L. George, “Structure, Governance, Representation: Federal Reserve Member Banks and Federal Reserve Bank Stock,” July 2016. <https://www.kansascityfed.org/~/-/media/files/publicat/speeches/2016/structure-governance-representation.pdf>

⁶ Marvin Goodfriend, “Monetary Policy as a Carry Trade,” IMES Discussion Paper Series No. 2014-E-8, Bank of Japan, September 2014. https://pdfs.semanticscholar.org/596b/3815fb45d8fd6fd7b7c1b4a2fc6dacb0b04d.pdf?_ga=2.188435944.190354274.6.1581107605-2138291141.1581107605

legitimate by the legislature and the public, otherwise such initiatives will lack credibility essential for their effectiveness.”⁷

Furthermore, to maintain independence, policymakers must draw a bright line between monetary and fiscal policy actions. He said:

“The problem is to identify the limits of independence on monetary policy and credit policy to preserve a workable, sustainable division of responsibilities between the central bank and the fiscal authorities—the legislature and Treasury.”⁸

Arguably, this bright line faded in November 2008 when the Federal Reserve announced its first round of large-scale asset purchases consisting of \$100 billion of agency debt securities and \$500 billion of agency mortgage-backed securities (MBS). This program was expanded in March 2009 with the planned purchase of a total of \$1.25 trillion in MBS, \$200 billion in agency debt, along with \$300 billion in longer-term Treasury securities. Additional “open-ended” purchases of MBS were announced under the third round of LSAPs in September 2012. Today the Federal Reserve holds almost \$1.4 billion in MBS on its balance sheet, and the FOMC has indicated that it currently does not anticipate selling agency mortgage-backed securities as part of its policy normalization process. These holdings arguably blur the line between monetary policy and credit allocation.

To address this important distinction, Marvin proposed that the 1951 Treasury-Federal Reserve Accord on monetary policy be supplemented with a Treasury-Fed Accord on credit policy. He identified three key principles: First, as a long-run matter, a significant, sustained departure from a “Treasuries only” asset acquisition policy is incompatible with Fed

⁷ Marvin Goodfriend, “The Case for a Treasury-Federal Reserve Accord for Credit Policy,” Testimony before the Subcommittee on Monetary Policy and Trade of the Committee on Financial Services, U.S. House of Representatives, Washington, D.C. March 2014.

<https://pdfs.semanticscholar.org/896e/65a69106282deb5806c03da136c026d42176.pdf>

⁸ Ibid.

independence. Second, the Fed should adhere to “Treasury only” except for occasional, temporary, well-collateralized ordinary last-resort lending to solvent, supervised depository institutions. And third, Fed credit initiatives beyond ordinary last-resort lending should be undertaken only with prior agreement of the fiscal authorities, and only as bridge loans accompanied by take-outs arranged and guaranteed in advance by the fiscal authorities.

These principles are worth considering as the Federal Reserve contemplates its next encounter with the zero lower bound. The Federal Reserve’s ongoing review of its monetary policy strategy, tools, and communications necessarily has surfaced a number of possible approaches to address such a future encounter. Among the possibilities are things we have tried in the past, such as asset purchases and forward guidance. Other ideas have been more novel, such as average inflation targeting, yield curve control and, yes, even negative interest rates.

Marvin may be right that these things, particularly when they are controversial, take some getting used to. But as importantly, he was keenly focused on preserving the central bank’s integrity and independence at the same time. That perspective undoubtedly would serve us well today.