Requirements for the Fed to Describe Its Strategy

Testimony Before
The Committee on Banking, Housing, and Urban Affairs
United States Senate

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Chairman Shelby, Ranking Member Brown, and other members of the Committee, thank you for the opportunity to testify at this hearing on "Federal Reserve Accountability and Reform."

In my opening remarks I would like to focus on a particular reform that would improve the accountability and transparency of monetary policy and lead to better economic performance. The reform would simply require the Fed to describe its strategy for monetary policy. It is a reform about which both Chairman Shelby and Chairman Jeb Hensarling of the House Financial Services Committee asked Fed Chair Janet Yellen in their opening questions at the Congressional hearings last week. It has attracted a lot of attention and has led to discussion and debate in the media, in the markets, and among economists.

The prime example of such a reform is a bill which passed out of the House Financial Services Committee as Section 2 of HR 5018 last year.[1] This bill would require that the Fed "describe the strategy or rule of the Federal Open Market Committee for the systematic quantitative adjustment" of its policy instruments. It would be the Fed's job to choose the strategy and how to describe it. The Fed could change its strategy or deviate from it if circumstances called for a change, but the Fed would have to explain why.

In considering the merits of such a reform, I think it is important to emphasize the word *strategy* in the bill. Though monetary economists often use the word "rule" rather than strategy, the term rule can sometimes be intimidating if one imagines that a rules-based strategy must be purely mechanical, contrary to what I and others have argued for many years. The United States Congress through the Senate Banking Committee and the House Financial Services Committee is in a good position—and in a unique position in our government—to oversee monetary policy in a strategic rather than a tactical sense. The most effective way to exercise this oversight is to require that the Federal Reserve describe its strategy publicly as the House bill does.

Experienced public officials know the importance of having a strategy and the close connection between a strategy and a rules-based process. One of the most experienced, George Shultz, put it this way, and I quote[2] "Let me explain why I think it is important, based on my

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[1] For additional background on this general type of reform see John B. Taylor, "Legislating a Rule for Monetary Policy," *The Cato Journal*, 31 (3), Fall, 407-415, 2011.
[2] "The Importance of Rules-Based Policy in Practice, in *Frameworks for Central Banking in the Next Century*, Michael D. Bordo, William Dupor, and John B. Taylor (Eds.), A Special Issue on

own experience, to have a rules-based monetary policy. First of all, if you have policy rule, like a Taylor Rule, you have a strategy, which is sort of what it amounts to….And at least as I have observed from policy decisions over the years in various fields, if you have a strategy, you get somewhere. If you don't have a strategy, you are just a tactician at large and it doesn't add up. So a strategy is a key element in getting somewhere."

Fed Chair Janet Yellen made similar observations when she served on the Federal Reserve Board in the 1990s. In "Monetary Policy: Goals and Strategy" she explained that[3] "The existence of policy tradeoffs requires a strategy for managing them," and she described a policy rule (the Taylor rule) pointing out "several desirable features" it has "as a general strategy for conducting monetary policy." She also stated that "the framework of a Taylor-type rule could help the Federal Reserve communicate to the public the rationale behind policy moves, and how those moves are consistent with its objectives"

In testimony before the House Financial Services Committee last summer I described how experience and research by many people over many years has shown that a rules-based monetary strategy leads to good economic performance.[4] This view is based on historical and statistical evidence. During periods when policy is more rules-based as in much of the 1980s, 1990s, the economy has performed well. During periods such as the 1970s and the past decade when policy has been more discretionary, economic performance has been poor. The shifts in policy preceded the shifts in economic performance, which indicates that policy shifts cause the changes in performance.

In a compendium published just last December to mark the Centennial of the Federal Reserve, Michael Bordo, Richard Clarida, John Cochrane, Marvin Goodfriend, Jeffrey Lacker, Allan Meltzer, Lee Ohanian, David Papell, and Charles Plosser joined George Shultz in writing about the advantages of such a policy strategy.[5] Most also agreed that during the past decade the Fed has either moved away from a rules-based strategy or has not been clear about what the strategy is. As stated last week by monetary economists Michael Belongia and Peter Ireland[6] "For all the talk about 'transparency,'… the process—or rule—by which the FOMC intends to defend its two-percent inflation target remains unknown."

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the Occasion of the Centennial of the Founding of the Federal Reserve, *Journal of Economic Dynamics and Control,* Volume 49, December 2014

[3] Janet L. Yellen, "Monetary Policy: Goals and Strategy," Remarks to the National Association of Business Economics, Washington, D.C., March 13, 1996

[4] For a summary of the 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.

[5] *Frameworks for Central Banking in the Next Century,* Michael D. Bordo, William Dupor, and John B. Taylor (Eds.), A Special Issue on the Occasion of the Centennial of the Founding of the Federal Reserve, *Journal of Economics Dynamics and Control, Volume 49, December 2014*

[6] Michael Belongia and Peter Ireland, "Don't Audit the Fed, Restructure It," *e21* February 19, 2015

Hearings specifically about this reform and other hearings such as those with Chair Yellen last week have been useful for getting input and finding the best way forward. But concerns and misunderstandings persist. For example, in answering questions from Chairman Shelby last week, Fed Chair Yellen stated that "I am not a proponent of chaining the Federal Open Market Committee in its decision making to any rule whatsoever." And the next day she repeated that view to Chairman Hensarling, saying "I don't believe that the Fed should chain itself to any mechanical rule." And in both hearings she quoted me saying that the Fed should not follow a mechanical rule. But the House monetary strategy bill, or similar proposals, would not chain the Fed to any rule. First, the Fed would choose and describe its own strategy, and it need not be a mechanical rule. Second, the Fed could change the strategy if the world changed, or it could deviate from the strategy in a crisis; so it would not be "chained." The Fed would have to report the reasons for the changes or departures, but, as in the example of departing from the policy rule during the stock market break in 1987, which Chair Yellen referred to, it would not be difficult to explain such adjustments.

Another concern has been raised by those who warn that by publicly describing its policy strategy, the Fed would lose independence. In my view, based on my own experience in government, the opposite is more likely. A clear public strategy helps prevent policy makers from bending to pressure. Moreover, de jure central bank independence alone has not prevented departures from a rules-based strategy. De jure central bank independence has been virtually unchanged in the past 50 years, yet policy makers have varied their adherence to rules-based policy. These variations demonstrate the need for legislation requiring the Fed to set and clarify its strategy for its policy instruments.

Some have expressed concern that a rules-based strategy would be too rigid. But the reform provides flexibility. It would allow the Fed to serve as lender of last resort or take appropriate actions in the event of a crisis. A policy strategy or rule does not require that any instrument of policy be fixed, but rather that it flexibly adjusts up or down to economic developments in a systematic and predictable way that can be explained. Moreover, as I indicated, the reform allows the Fed to change its rule or deviate from it.

Another concern is expressed by those who claim that the House monetary strategy bill would require the Fed to follow the Taylor Rule; but this is not the case. The bill does require the Fed to describe how its strategy or rule might differ from a "reference rule," which happens to be the Taylor rule. However, describing the difference between a particular policy rule and this reference rule is a natural and routine task for the Fed. In fact, many at the Fed already make such comparisons including Fed Chair Yellen;[7] another recent example is the Fed staff paper that makes extensive use of the rule to measure the impact of the Fed's unconventional policies.[8]

It is important to point out that there is precedent for this type of Congressional oversight. Previous legislation, which appeared in the Federal Reserve Act from 1977 to 2000, required

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[7] Janet Yellen, "The Economic Outlook and Monetary Policy, Money Marketeers, New York, New York April 11, 2012

[8] Eric Engen, Thomas Laubach, and David Reifschneider "The Macroeconomic Effects of the Federal Reserve's Unconventional Monetary Policies," January 14, 2015

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 requirement 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 reform is needed simply to fill that void.

In my view the Congress and this Committee now have an opportunity to move forward on such a reform in a non-partisan way with constructive input from the Fed. The result would be a more effective monetary policy based on a strategy to achieve the goals of a better performing economy which we all share. I would be happy to answer any questions you may have about this reform or others.