

Federal Reserve Reform Proposals

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Chair Huizenga, Ranking Member Moore, and members of the Subcommittee on Monetary Policy and Trade, thank you for inviting me to testify at this hearing on “Examining Federal Reserve Reform Proposals,” including the Federal Reserve Reform Act of 2015 and the Centennial Monetary Commission Act of 2015.

The Federal Reserve Reform Act of 2015—as stated in Section 2, Requirements for Policy Rules of the Federal Open Market Committee—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.² According to the bill, the Fed would choose the strategy and how to describe it. The Fed could change its strategy or deviate from it if circumstances called for a change, in which case the Fed would have to explain why.

In evaluating this bill it is important to emphasize the word “strategy” as explicitly stated in the bill. Though economists frequently use the word “rule,” that term may convey the false idea that a rules-based monetary strategy must be purely mechanical. In a conference volume³ published last December, George Shultz explained the importance of having a strategy. He wrote that “...it is important, based on my own experience, to have a rules-based monetary policy.... 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.” Fed Chair Janet Yellen similarly explained in a speech⁴ in the 1990s that “The existence of policy tradeoffs requires a strategy for managing them,” and she described a rule for

¹ Mary and Robert Raymond Professor of Economics at Stanford University, George P. Shultz Senior Fellow in Economics at Stanford’s Hoover Institution, and former Under Secretary of Treasury for International Affairs, 2001-2005.

² This written testimony focusses on Section 2 of the bill and concentrates on issues raised during the year since I testified on this subject at the Committee on Financial Services in July 2014. See John B. Taylor, “Requirements for Policy Rules for the Fed,” Testimony before the Committee on Financial Services, United States House of Representatives, July 10, 2014.

³ “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.), *Journal of Economic Dynamics and Control*, Volume 49, December 2014

⁴ Janet L. Yellen, “Monetary Policy: Goals and Strategy,” Remarks to the National Association of Business Economics, Washington, D.C., March 13, 1996

the policy instruments with “several desirable features” as an example of “a general strategy for conducting monetary policy.”

The finding that predictable rules-based monetary policy is essential for good economic performance comes from research by many people and from practical experience over many years in the United States and other countries. My own research going back more than four decades supports this view, and such a view has become embedded in macroeconomic theory.⁵ In the same conference volume where the quoted words of George Shultz appear, other economists, including Michael Bordo, Richard Clarida, John Cochrane, Marvin Goodfriend, Jeffrey Lacker, Allan Meltzer, Lee Ohanian, David Papell, and Charles Plosser, wrote about the advantages of such a policy strategy; yet, most 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.

Of course, it is possible technically for the Fed to get back to such a strategy, but it is difficult in practice. Long departures from a rules-based strategy in the 1970s and in recent years illustrate the difficulty. De jure central bank independence alone has not prevented departures. 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 point to the need for the Federal Reserve Reform Act of 2015 which would require the Fed to set and clarify its strategy for its policy instruments.

There is precedent for this type of Congressional oversight. Legislation that appeared in the Federal Reserve Act from 1977 to 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 requirement for reporting ranges for the monetary aggregates was removed from the law in 2000, nothing was put in its place. A legislative void was thus created concerning reporting requirements and accountability. The proposed legislative reform would help fill that void.

The United States Congress through the House Financial Services Committee and Senate Banking Committee has responsibility for the oversight of monetary policy in this strategic sense. Allan Meltzer stressed this idea in a recent Senate Banking Committee hearing,⁶ saying “We need change to improve the oversight that [Congress]...exercises over the Fed....you need a rule which says, look, you said you were going to do this, and you have not done it. That requires an answer, and that I think is one of the most important reasons why we need some kind of a rule.”

⁵ See John B. Taylor “Getting Back to a Rules-Based Monetary Strategy,” presented at the Conference “Getting Monetary Policy Back on Track,” organized by the Shadow Open Market Committee, Princeton Club, New York City, March 20, 2015, from which this testimony draws directly.

⁶ Transcript, Hearing before The Committee on Banking, Housing, and Urban Affairs United States Senate, March 3, 2015

During the past year there has been extensive discussion and debate in the Congress and in the media about the ideas underlying the policy rules bill. Recently new economic research at universities and think tanks has begun to address the issue.⁷ A bill with close similarities to the Federal Reserve Reform Act of 2015 has been voted out of the Senate Banking Committee.

The Centennial Monetary Commission Act of 2015, which would establish a Centennial Monetary Commission to study monetary policy, would be a constructive way to bring this research together, and discuss it and expand it as necessary in a bipartisan context and perhaps come to conclusion. It would be useful, for example, to constructively address concerns about monetary policy and reform proposals that have been raised during the past year. Let me consider several of these concerns.

Fed Chair Janet Yellen testified⁸ that “I don’t believe that the Fed should chain itself to any mechanical rule.” But the bill does not chain the Fed to any rule. The Fed would choose and describe its own strategy, and it need not be mechanical. The Fed could change the strategy if the world changed. It could deviate from the strategy in a crisis if it explained why. It would still serve as lender of last resort or take appropriate actions in the event of a crisis. Moreover, 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.

Another stated concern with policy rules legislation is that the Fed would lose its 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 under pressure and sacrificing their institution’s independence.

Some commentators say that the bill would require the Fed to follow a particular rule listed in the bill, but this is not the case. The bill requires 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 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 Chair Yellen.

The false claim that the bill would chain the Fed to the reference rule leads to other questions. For example, Ranking Member Gwen Moore asked Chair Janet Yellen in a hearing on July 15 whether the Fed would be able to react to the Greek crisis if it were required to follow the Taylor rule. Chair Yellen noted that that rule focusses on two variables and thus would not allow such a reaction. Leaving aside the question of whether the Fed should have reacted to the Greek crisis, the legislation would not have prevented it from doing so, because the Fed would choose the rule and it could deviate from it.

⁷ See, for example, Alex Nikolsko-Rzhevskyy, David H. Papell, and Ruxandra Prodan “Policy Rule Legislation in Practice” and Carl E. Walsh “Goals and Rules in Central Bank Design” both forthcoming in *Central Bank Governance and Oversight Reform*, John H. Cochrane and John B. Taylor (Eds.), Hoover Press

⁸ House Financial Services Committee Hearing entitled “Monetary Policy and the State of the Economy,” February 25, 2015

Some say that uncertainty about the output gap makes any rule that depends on the gap inferior to discretion. But uncertainty about the output gap is just as much a problem for discretion as it is for policy rules.

Another critique is that the zero bound on the interest rate means that an interest rate rule is no longer useful. Wasn't that the reason that the Fed deviated from rules-based policy in recent years? It was certainly not a reason in 2003-2005 and it is not a reason now, because the zero bound is not binding. It appears that there was a short period in 2009 when zero was clearly binding. But the zero bound is not a new thing in economics research. Policy rule design research took that into account long ago. One approach was to recognize that in such a situation one should simply keep money growth steady rather than embarking on a purely discretionary policy such as quantitative easing.

There is also the concern that there are many rules or strategies to choose from. There are many different types of personal display devices, but that does mean they are all useless. Some policy strategies are better than others, and it makes perfect sense for researchers and policy makers to be looking for new and better ones. Some people have suggested focusing on nominal GDP. I do not think adding housing prices or the stock market to a rule makes much sense, but with the policy rules legislation it is the job of the Fed to decide

Some of the recent objections to predictable policy rules and the enabling legislation go to the heart of an old debate about rules versus discretion. Lawrence Summers raised this one: "I think about my doctor. Which would I prefer: for my doctor's advice, to be consistently predictable, or for my doctor's advice to be responsive to the medical condition with which I present? Me, I'd rather have a doctor who most of the time didn't tell me to take some stuff, and every once in a while said I needed to ingest some stuff into my body in response to the particular problem that I had. That would be a doctor who's [advice], believe me, would be less predictable."⁹

This line of argument in favor of pure discretion appeals to an all-knowing expert, a doctor who does not perceive the need for, and does not use, a set of guidelines, but who once in a while in an unpredictable way says to ingest some stuff. But as in economics, there has been progress in medicine over the years. And much progress has been due to doctors using checklists. Experience shows that checklists are invaluable for preventing mistakes, getting good diagnoses and appropriate treatments. Of course doctors need to exercise judgement in implementing checklists, but if they start winging it or skipping steps the patients usually suffer. Experience and empirical studies show that a checklist-free medicine is wrought with dangers just as a rules-free monetary policy.

Another line of argument is that you do not really need a rule or strategy for the instruments of policy. All you really need for effective policy making is a goal, such as an inflation target and an employment target. In medicine, it would be the goal of a healthy patient. The rest of policymaking is doing whatever you as an expert, or you as an expert with models,

⁹ Transcript published in the *Journal of Policy Modeling*, Issue 4, Volume 36, 2013

thinks needs to be done with the instruments. You do not need to articulate or describe a strategy, a decision rule, or a contingency plan for the instruments. If you want to hold the interest rate well below the rule-based strategy that worked well during the Great Moderation, as the Fed did in 2003-2005, then it's ok as long as you can justify it at the moment in terms of the goal.

Ben Bernanke and others have called this approach “constrained discretion.”¹⁰ It is an appealing term, and it may be constraining discretion in some sense, but it is not inducing or encouraging a rule or a strategy. Simply having a specific numerical goal is not a rule for the instruments of policy; it is not a strategy; in my view, it ends up being all tactics. I think the evidence shows that relying solely on constrained discretion has not worked for monetary policy.

I would be happy to answer questions about this testimony on Section 2 of Federal Reserve Reform Act of 2015, the Centennial Monetary Commission Act of 2015 or any other questions that you may have about the Federal Reserve reform proposals.

¹⁰ Ben S. Bernanke "Constrained Discretion and Monetary Policy," remarks before the Money Marketeers of New York University, February 3, 2003