Legislating a Rule for Monetary Policy

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In these remarks I discuss a proposal to legislate a rule for monetary policy. The proposal modernizes laws first passed in the late 1970s, but largely discarded in 2000.

A number of years ago I proposed a simple rule as a guideline for monetary policy.[1] I made no suggestion then that the rule should be written into law, or even that it be used to monitor policy, or hold central banks accountable. The objective was to help central bankers make their interest rate decisions in a less discretionary and more rule-like manner, and thereby achieve the goal of price stability and economic stability. The rule incorporated what we learned from research on optimal design of monetary rules in the years before.

In the years since then we have learned much more. We learned that such simple rules are robust to widely different views about how monetary policy works (see Taylor and Williams 2011). We learned that such rules are frequently used by financial market analysts in their assessment of policy and by policymakers in their own deliberations (see Asso, Kahn, and Leeson 2007). We learned that when policy is close to such rules, economic performance is good: inflation is low, expansions are long, unemployment is low, and recessions are

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[1]See Taylor (1993) and also the *Economic Report of the President* (1990: 85) where the idea of such a systemic policy was described in less technical and less quantitative language.

short, shallow, and infrequent; but when policy is short-term focused and deviates from such rules, economic performance is poor (see Meltzer 2009).

Why legislate a policy rule now? Because monetary policy has recently become more discretionary, more short-term focused, much less rule-like than it was in the 1980s and 1990s, and economic performance has deteriorated. A legislated rule can reverse the short-term focus of policy and restore credibility in sound monetary principles consistent with long-term price stability and strong economic growth.

Signs of a shift toward more discretion appeared as far back as 2002–04, when the policy interest rate was held below settings that worked well during the 1980s and 1990s. But policymakers have doubled down on discretion since then. When the bursting housing bubble led to tensions in the financial markets in 2007, policymakers used the central bank's balance sheet to finance an ad hoc and chaotic series of bailouts which led to the panic in the fall of 2008. After helping to arrest the panic, they then further expanded the balance sheet in order to finance massive purchases of mortgage-backed and Treasury securities (the first tranche of so-called quantitative easing, or QE1). And now they have embarked on yet another program of large-scale purchases (QE2), which increases risks about inflation down the road or further disruptions when the balance sheet is scaled back. A legislated rule would increase certainty that the size of the balance sheet will be reduced in a timely and predictable manner and thereby reduce this risk.

My research shows that these discretionary actions were, on balance, harmful. But even if one disagrees, the actions should raise concerns about a monetary system in which a great deal of power is vested in an organization with little accountability and without checks and balances. The purchase of mortgage-backed securities explicitly shifts funds to one sector and away from others, an action which should be approved by Congress. Putting taxpayer funds at risk is a credit subsidy, which should be appropriated by Congress. Some of the discretionary actions are inconsistent with the intent of the Constitution because they take monetary policy into fiscal or credit allocation areas and thereby circumvent the appropriations process. The recent QE2 action irritated many countries around the world, and may have impacted U.S. foreign policy by affecting the ability of the United States to negotiate positions at the recent G20 meeting.

In sum, these recent discretionary actions, combined with the success of a more strategic rule-like policy in the decades before, raise the question of legislating rules for monetary policy.

While passing such legislation necessarily involves the president and the Congress of the United States, it does not mean that the president or Congress should insert themselves in the operational decisionmaking process of the Federal Reserve. Indeed, legislation in the 1970s, which I will summarize here, was constructive in bringing about longer-term reforms at the Federal Reserve, as described positively in a retrospective by Ben Bernanke (2008: 177): "The Congress has also long been aware of the importance of Federal Reserve transparency and accountability. In particular, a series of resolutions and laws passed in the 1970s set clear policy objectives for the Federal Reserve and required it to provide regular reports and testimony to the Congress."[2]

The objective, as Milton Friedman (1962: 51) said many years ago, is to find a way of "legislating rules for the conduct of monetary policy that will have the effect of enabling the public to exercise control over monetary policy through its political authorities, while at the same time it will prevent monetary policy from being subject to the day-by-day whim of political authorities."

Brief Review of Legislation

Though modern monetary rules focus on the interest rate, much can be learned from the history of legislation relating to the monetary aggregates. Such legislation includes House Concurrent Resolution 133 of 1975, the Federal Reserve Reform Act of 1977, the Full Employment and Balanced Growth Act of 1978, and the American Homeownership and Economic Opportunity Act of 2000.

House Congressional Resolution 133 was adopted on March 24, 1975, just as the recession of 1973–75 was reaching its trough. Early versions of the resolution called on the Fed to increase the money supply and reduce interest rates, which was certainly not consistent with the Congress staying out of the day-to-day operations of the Fed. But after extensive discussions with the Fed, including testimony by Arthur Burns, the final version focused on requirements to report

[2]Bernanke first made these remarks at the Cato Institute's 25th Annual Monetary Conference, November 14, 2007.

and testify about the growth of monetary and credit aggregates. In particular the Resolution said that "the Board of Governors shall consult with Congress at semi-annual hearings . . . about the Board of Governors' and the Federal Open Market Committee's objectives and plans with respect to the ranges of growth or diminution of monetary and credit aggregates in the upcoming twelve months."

William Poole (1976), in one of the first economic assessments of the Resolution, was critical of how it was implemented, pointing to the problem of base drift. But the requirements to report and testify started a trend toward transparency and accountability which continued into the 1980s and 1990s.

Much of the money growth reporting language in Resolution 133 was incorporated into the Federal Reserve Reform Act of 1977. This reform act also added a new sentence (in Section 2A) on purpose and long-run goals, stating that: "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." This sentence has remained in the Federal Reserve Act ever since, and now constitutes the entirety of Section 2A.

The Full Employment and Balanced Growth Act of 1978 modified the reporting requirements of the Federal Reserve Act. It still focused on "the ranges of growth or diminution of the money and credit aggregates," but it called for a report and testimony in February and July of each year. The money growth ranges for the current calendar year would be given in the February report and testimony, and the ranges for the following calendar year in the July report and testimony, which gave a slightly longer-term focus.

Some ambiguity remained, however, about whether the Fed should be held accountable for deviations from these ranges. As amended in 1978 the Federal Reserve Act stated: "Nothing in this Act shall be interpreted to require that the objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates disclosed in the reports submitted under this section be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions: *Provided*, that in the subsequent consultations with, and reports to, the aforesaid Committees of the Congress pursuant to this section, the Board of Governors shall include an explanation of the reasons for any revisions to or deviations from such objectives and plans."

The required reporting on the monetary and credit aggregates was completely eliminated in the American Homeownership and Economic Opportunity Act of 2000, which struck everything after the statement of purpose sentence of Section 2A, and added a new Section 2B on testimony and reports to the Congress. These reports were to contain "a discussion of the conduct of monetary policy and economic developments and prospects for the future, taking into account past and prospective developments in employment, unemployment, production, investment, real income, productivity, exchange rates, international trade and payments, and prices." Thus, reporting about the ranges for growth of the monetary aggregates was eliminated.

Along with these changes in reporting requirements came an end to the Fed's establishing ranges for the monetary aggregates. The Monetary Policy Report of July 20, 2000, explained in a footnote that "At its June [2000] meeting, the FOMC did not establish ranges for growth of money and debt in 2000 and 2001. The legal requirement to establish and to announce such ranges had expired, and owing to uncertainties about the behavior of the velocities of debt and money, these ranges for many years have not provided useful benchmarks for the conduct of monetary policy." Later, in its Monetary Policy Report of February 15, 2006, the Fed announced that it would no longer even publish data on M3 because such publication "was judged to be no longer generating sufficient benefit in the analysis of the economy or of the financial sector to justify the costs of publication."

Four things can be taken away from this short review. First, the legislation only required *reporting* of the ranges of the monetary aggregates, not that they be set in any particular way, certainly nothing close to a rule such as keeping the growth rate of money constant over time and equal to some specific percent. The Fed had full discretion to choose both the aggregates and the ranges. Second, the ranges were not really used as a measure of accountability. Though the proviso language required some justification for deviations, the reduced reliability of the aggregates as instruments of monetary policy and the increasing focus on the interest rate instrument in the 1980s and 1990s rendered accounting for deviations meaningless. Third, the reporting requirements changed over time. Most importantly, when the monetary aggregates became less reliable, the requirements for reporting about them were eliminated. Fourth, when the ranges for the monetary aggregates were finally removed from the legislation in 2000, nothing comparable about the interest rate instrument was put in their place. A legislative void was created concerning reporting requirements and accountability. You could say that the reporting-accountability baby was thrown out with the monetary aggregate bathwater.

Proposed Legislative Changes

The most straightforward way to legislate a rule for monetary policy would be to fill this void by reinstating reporting requirements and accountability requirements that were removed from the Federal Reserve Act by the American Homeownership and Opportunity Act of 2000. But rather than focus on "ranges of growth or diminution of the money and credit aggregates," it would focus directly on the rule-like response of the federal funds rate.

The proposed legislation—call it the Federal Reserve Policy Rule Act—would first repeal the parts of the American Homeownership and Opportunity Act of 2000 pertaining to monetary policy, which are in Title X, Section 1003. It would then use much of the language in the reporting and accountability sections of Federal Reserve Act as it existed just prior to the passage of the 2000 Act, but modernized to incorporate policy decisions about the interest rate.

Reporting Requirements

The reporting section of the legislation would thus state that "The Board of Governors of the Federal Reserve System shall transmit to the Congress no later than February 20 and July 20 of each year a written report setting forth (1) the strategy, or rule, of the Board and the FOMC for the systematic adjustment of the federal funds rate in response to changes in inflation and in the real economy during the current year and future years, along with any additional systematic adjustments needed to achieve the price stability objective, (2) the procedure for adjusting the supply of bank reserves to bring about the desired federal funds rate, recognizing that the rate is determined by the supply and demand for reserves in the money market." Because of the large current size of the Fed's balance sheet, a transitional exit rule to reduce bank reserves in a predictable way would also need to be established and reported.[3]

Accountability Requirements

The accountability parts of the new law would also build on the Federal Reserve Act prior to 2000 and say that "Nothing in this Act shall be interpreted to require that the plans with respect to the systematic quantitative adjustment of the federal funds rate disclosed in the reports submitted under this section be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions: *Provided*, that in the subsequent consultations with, and reports to, the Committees of the Congress pursuant to this section, the Board of Governors shall include an explanation of the reasons for any revisions to or deviations from the rule for the systematic quantitative adjustments of the federal funds rate."[4]

This accountability language could be strengthened by not permitting any deviations from the rule, but that does not seem reasonable. As explained in Levin and Taylor (2010), "On occasion, of course, policymakers might find compelling reasons to modify, adjust, or depart from the prescriptions of any simple rule, but in those circumstances, transparency and credibility might well call for clear communication about the rationale for that policy strategy." In my view, the requirement to explain deviations as soon as they were apparent, or at the next scheduled hearing would be conducive to better policy. There are many examples now of economists examining deviations from policy rules, though usually long after the fact. It may be more difficult in real time, but it is certainly feasible.

This proposal would limit the Fed's discretion by requiring that it establish and report on a policy rule for the federal funds rate. For example, if the Fed decides to use the Taylor Rule,[5] it would meet reporting requirement number (1) of the proposed law by reporting that its systematic interest rate adjustment is 1.5 percent for each percent change in inflation and 0.5 percent for each percent

[3]For a specific example of such an exit rule, see Taylor (2010).

[4]The italics were in the Federal Reserve Act

[5]This rule says that the interest rate should be set to equal one-and-a-half times the inflation rate plus one-half times the GDP gap plus one. The GDP gap is the percentage difference between real GDP and potential GDP (see Taylor 1993).

difference between real GDP and potential GDP; then a fixed adjustment of +1 would be needed to achieve an inflation goal of 2 percent.

The proposal does not require that the Fed choose any particular rule for the interest rate, only that it establish some rule and report what the rule is. For example, the Board of Governors and the FOMC could decide that their strategy does not entail any response to changes in real GDP and that they will only respond to inflation as measured by a commodity price index. If the Fed's experience dealing with the mandate to establish and report growth rates for the monetary aggregates in the late 1970s and 1980s is any guide, the mere effort to establish such a strategy will be constructive. But if the Fed deviates from its chosen strategy, the Board of Governors must provide a written explanation and answer questions at a congressional hearing. So while the proposal limits discretion, it does not eliminate discretion. It provides a degree of control by the political authorities without interfering in the day-to-day operations of monetary policy.

Conclusion

I have tried in these remarks to show why it is important for price stability and economic growth to restore a more strategic rule-like monetary policy with less short-term oriented discretionary actions. By reviewing U.S. legislative history since the late 1970s, I have shown that it possible to legislate a rule for monetary policy such as the one that worked well in the 1980s and 1990s, and I have written some illustrative legislative language. Such legislation would also bolster the independence of the Federal Reserve by increasing accountability and reducing the tendency to take discretionary actions which venture into fiscal or credit allocation policy.

There are of course alternative ways to limit discretion, some of which are not mutually exclusive with the proposals here, such as removing or modifying the "maximum employment" term in Section 2A, which, as I described earlier, has been carried over from outmoded views about the relation between unemployment and inflation. But in the current circumstances, it is important to get started. By building on experience and the legislative history of the Federal Reserve Act as it pertains to reporting and accountability for the instruments of policy, the legislative change proposed here is a reasonable and practical place to begin.

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