EXAMINING FEDERAL RESERVE REFORM PROPOSALS

HEARING

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EXAMINING FEDERAL RESERVE REFORM PROPOSALS

Wednesday, July 22, 2015

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON MONETARY
POLICY AND TRADE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:08 a.m., in room 2128, Rayburn House Office Building, Hon. Bill Huizenga [chairman of the subcommittee] presiding.

Members present: Representatives Huizenga, Mulvaney, Lucas, Pearce, Stutzman, Pittenger, Messer, Schweikert, Guinta, Love, Emmer; Moore, Foster, Himes, Carney, Murphy, Kildee, and Heck.

Ex officio present: Representative Hensarling.

Also present: Representatives King and Green.

Chairman HUIZENGA. The Subcommittee on Monetary Policy and Trade will come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Today's hearing is entitled, "Examining Federal Reserve Reform Proposals."

I now recognize myself for 2 minutes to give an opening statement.

The Federal Reserve System was created in 1913 with a mission of establishing three key objectives for monetary policy: maximum employment; price stability; and moderate long-term interest rates. However, last Congress, as we examined the Fed's actions over the last 100 years, through the Federal Reserve Centennial Oversight Project, it became clear that the Federal Reserve has gone above and beyond its original mission statement.

In fact, since the enactment of the Dodd-Frank Act, the Federal Reserve has gained unprecedented power, influence, and control over the financial system while remaining shrouded in mystery to the American people. This hearing provides us with another opportunity to examine how the Federal Reserve conducts monetary policy and why the development of these policies is in desperate need of transparency, in my opinion.

The Fed's recent high degree of discretion and its lack of transparency in how it conducts monetary policy demonstrates that not only are reforms needed but, more importantly, that reforms are necessary. Today, the Fed's balance sheet is almost 5 times the size of its pre-crisis level and represents one-quarter of the size of the entire U.S. economy. That is a tremendous amount of money.

The Fed's balance sheet demonstrates attempts to push monetary policy past its most basic mandate: price stability. Absent a monetary policy that dutifully promotes price stability, economic opportunity will continue to fall short of its potential. I have continued to encourage the Federal Reserve, both publicly and privately, to adopt a rules-based approach to monetary policy and communicate that rule to the public.

As anyone who has been paying attention to it knows, the Fed has not seen a clear path to go in that direction, so we are here to help nudge them along. The Fed also, I believe, most importantly, must be accountable to the people's representatives as well as the hard-working taxpayers themselves.

With that, I yield back the balance of my time.

I recognize the gentlelady from Wisconsin, Ms. Moore, for 3 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman.

Today, we are here examining two proposals: the first would create a partisan commission to review the Fed's dual mandate; and the second would permit policy audits of the Federal Reserve and establish a computer model to govern monetary policy.

I think there may be some legitimacy to some of the concerns my Republican colleagues have raised regarding the Fed, but these two bills are answers to problems that really don't exist. If we are worried about the Fed's growth policies, why don't we meet the Fed halfway, and stop the misguided obsession with austerity and trying to trick the economy to grow the economy?

If you want the Fed to feel comfortable going to a more traditional monetary policy, you don't need all these bills. Why don't my colleagues join Democrats in supporting proven growth policies like extension of the Ex-Im Bank, providing a living wage for workers, a long-term highway bill that used to be bipartisan, equal pay for women, sick leave, or training a 21st Century workforce by improving public education?

I strongly support the dual mandate. It reflects the reality of monetary policy. I don't know how anyone can be against weighting employment as the consideration of economic growth goals.

As for auditing the Fed and establishing a computer model-based monetary policy, I can tell you, I am so certainly unsure about the level of concern for the U.S. credit rating agencies anymore after some of our colleagues have called for a default on U.S. debt. However, our central bank's independence is a consideration of credit rating agencies. These are established benefits of independent central banks. Injecting politics into monetary policy would be a disaster.

I see this computer model as extremely dangerous. Both Fed Chair Yellen and former Fed Chair Bernanke feel that this would be flawed, and tell us that it would impede the Fed's ability to act in a crisis. Banks and Wall Street investors would all set their trading and projections to whatever the so-called Taylor Rule computer model we adopt would be, and the potential disruption of any deviation from the model would cause all kind of market disruption and thus effectively take away any discretion from the Fed. I would oppose both bills in their current form.

I look forward to our distinguished panel, and I yield back the length, the balance of this long time I have.

Chairman HUIZENGA. The gentlelady's time has expired.

With that, the Chair recognizes the gentleman from New Hampshire, Mr. Guinta, for 1 minute for an opening statement.

Mr. GUINTA. Thank you, Mr. Chairman.

I welcome the panel. And thank you for being here today for this very important hearing.

From 2007 to 2012, we saw the average median income decrease in 5 consecutive years, and since then, we have arguably the slowest economic recovery since World War II. Last month's Investor's Business Daily report reported that overall growth in the last 23 quarters of the Obama recovery has been at about 13.3 percent. The average growth rate achieved since World War II is 26.7 percent. Obama's recovery is half the average.

If our growth rate under President Obama was simply average, it has been reported that our GDP would be $1.9 trillion larger today. That is roughly $16,000 more per household. On top of our sluggish economy, we have Americans who are seeing near zero interest rates on their savings accounts while median incomes are not increasing as quickly as they should be.

Millions of Americans are dealing with fluctuating gas prices, higher food and electricity prices, and increasing healthcare costs. And this is why we need transparency within the Federal Reserve. It is time to open up the books and take a look at what the Fed is doing.

I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

The Chair recognizes Mr. Himes of Connecticut for 2 minutes for an opening statement.

Mr. HIMES. Thank you, Mr. Chairman.

And thank you to the panel for being here.

I wanted to be in this hearing because I find the idea of examining the Federal Reserve reform proposals both ironic and, to some extent, profoundly concerning. It is ironic because, of course, the bad actors since 2006, 2007, 2008—Fannie Mae, Freddie Mac, the GSEs—generally remain unreformed. Shame on both parties for that. The banking industry and all of its associated people have been reformed. And, of course, my friends on the other side of the aisle would like to do away with that reform.

And, of course, history will not treat this institution kindly with respect to the way we responded in fiscal policy over the last several years. And yet, it is the Federal Reserve, the one entity that I think can be called probably the hero of the last 6 years, through their expansionary monetary policy, through their use of extraordinary and, yes, somewhat concerning authorities to yank us out of a recession—some say not rapidly enough—but unquestionably yanked us out of a recession. And yet, it is they that we are talking about reforming.

We have interesting debates in this room, including the role of the government in flood insurance and mortgage insurance. And these are really interesting debates that we ought to have.

This is different. And this is where I am profoundly concerned. An independent Federal Reserve, a monetary authority that is not subject to the tender mercies of this institution is a cornerstone of our economy. And, frankly, that is true across time and across geographies.

Many of the proposals being entertained today would erode that independence. This is not a question subject to debate. There is plenty of academic research, most notably that undertaken by Larry Summers and Alberto Alesina in 1993, which shows that there is a very strong correlation between monetary policy independence and inflation. Independent institutions run better economies than those that are not.

The objection is made that it should be transparent. It should be transparent. The Federal Reserve, of course, in the last 50 years has become much more transparent. But above all else, we need to be very, very careful that we do not damage the monetary independence in the Federal Reserve through any efforts to improve the transparency of that institution.

Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the Chair recognizes the gentleman from Minnesota, Mr. Emmer, for 1 minute for an opening statement.

Mr. EMMER. First, I want to thank the chairman for calling this hearing and to thank the witnesses for being here today.

Despite the differences of opinion that we know are in this room, it is my hope that we can work together to make the Federal Reserve even more transparent and a market-friendly institution.

As you know, the Fed has immense influence over capital markets, financial institutions, and the American economy. Since the Great Recession, the Fed has used its nearly unlimited, broad, and assumed powers to push interest rates to historical lows by trillions of dollars of toxic assets and bail out numerous financial institutions. That is why I have joined many of my colleagues and my constituents with grave concerns that short-term solutions enacted by the Fed have harmed future prosperity and the people's faith in their institutions.

For these reasons, I am more than pleased that Chair Huizenga's Federal Reserve Reform Act and Mr. Brady's Centennial Monetary Commission Act have been proposed. I see these bills as important steps towards responsible oversight and a pro-growth economy.

And with that, Mr. Chairman, I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

Before we proceed, without objection, members of the full Financial Services Committee who are not members of the subcommittee may participate in today's hearing.

Without objection, it is so ordered.

With that, we would like to welcome some very esteemed colleagues and doctors who are going to be here with us today examining these various proposals. We are going to welcome the testimony of Dr. John Taylor, professor of economics at Stanford University; Dr. John Cochrane, senior fellow with the Hoover Institution; Dr. Donald Kohn, senior fellow in economic studies at the Brookings Institution; and rounding us out, Dr. Paul Kupiec, resident scholar at the American Enterprise Institute.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony.

And without objection, each of your written statements will be made a part of the record.

And, with that, Dr. Taylor, you are now recognized for 5 minutes for your opening statement.

STATEMENT OF JOHN B. TAYLOR, MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

Mr. TAYLOR. Thank you, Mr. Chairman, and Ranking Member Moore, for inviting me to this subcommittee hearing.

I would like to focus on Section 2 of the Federal Reserve Reform Act in these opening remarks. That section requires that the Fed describe the strategy or rule of the Federal Open Market Committee (FOMC) for the systemic quantitative adjustment of its policy instruments. The Fed would choose the strategy. The Fed could change its strategy or deviate from the strategy, but it would have to explain why.

In discussing the bill, I would like to emphasize the word "strategy" because the word "rule," though frequently used by economists, may convey the false idea that a rules-based monetary strategy is mechanical or mathematical. Practical experience and economic research over many years shows that a clear monetary strategy is essential for good economic performance. My own research, going back more than 4 decades, supports this view, yet many agree that during the past decade, the Fed has either moved away from a strategy or has not been clear about the strategy.

It is, of course, possible, technically, for the Fed to get back to and adhere to such a strategy, but it is difficult in practice. And for this reason, I think the Federal Reserve Reform Act of 2015 is needed.

Congress has responsibility for oversight of policy in the strategic sense, and there is precedent. From 1977 to 2000, Congress required the Fed to report money growth ranges. The requirement was repealed but not replaced. The proposed policy strategy requirement is an excellent replacement.

During the past year, there has been extensive discussion about the bill. A similar bill was voted out of the Senate Banking Committee, and new economic research has begun. The proposed Centennial Monetary Commission would be a constructive way to bring this discussion together in a bipartisan context. It would be useful to constructively address the concerns raised during the past year.

Fed Chair Janet Yellen, for example, testified that she did not believe the Fed should chain itself to any mechanical rule. But the bill does not chain the Fed to any such rule. The Fed would choose and describe its own strategy. It could deviate from the strategy in a crisis if it explained why.

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 policymakers from bending under pressure and sacrificing their institution's independence.

Some say the bill would require the Fed to follow a particular rule, but this isn't the case. The bill simply requires that the Fed compare its strategy with a reference rule. Many at the Fed already make such comparisons.

That false claim that the bill would chain the Fed leads to other questions. Last week, Ranking Member Moore asked Chair Yellen whether the Fed would be able to react to the Greek crisis if it were required to follow the so-called Taylor Rule. Leaving aside whether the Fed should have reacted to the crisis, the legislation would in no way have prevented it from doing so.

Another critique is that the zero bound on the interest rate means you have to abandon rules-based strategy. Wasn't that why the Fed deviated from rules-based policy in recent years? Not in 2003, 2005, and not now because the zero bound is not binding. It appears that there was a period in 2009 when the zero was binding, but that is not a new thing. Policy research design has looked into that issue on the go. One approach would simply be to keep money growth steady.

Some recent objections revive old debates. Larry Summers, for example, makes an analogy with medicine, saying he would prefer a doctor who just gave him good medicine rather than one who is predictable or follows the strategy. But this ignores progress in medicine due to doctors using checklists. Experience shows that checklists are invaluable for preventing mistakes, getting good diagnoses, and appropriate treatments. Checklists-free medicine is as wrought with as many dangers as rules-free monetary policy.

Some say you don't really need a rule or a strategy for the instruments of policy as long as you have an inflation target or an employment target. In fact, Ben Bernanke has called this approach "constrained discretion." But having a specific numerical goal is not a strategy for the instruments of policy. It ends up being all tactics. Relying on constrained discretion rather than a strategy for the instruments of monetary policy just hasn't worked.

Thank you very much. I would be happy to answer any of your questions.

[The prepared statement of Dr. Taylor can be found on page 65 of the appendix.]

Chairman HUIZENGA. Thank you, Dr. Taylor.

And, with that, Dr. John Cochrane, you have 5 minutes as well for your opening statement.

STATEMENT OF JOHN H. COCHRANE, SENIOR FELLOW, HOOVER INSTITUTION, STANFORD UNIVERSITY

Mr. COCHRANE. Chairman Huizenga and Ranking Member Moore, thanks very much for the opportunity to testify.

I think it is wise for Congress to rethink the fundamental structures under which the Federal Reserve operates from time to time, and I think the Fed wants guidance as much as you want clarity. The Fed enjoys great independence, and that is widely viewed as a good thing. But in our democracy, independence must be paired with limited powers. The Fed cannot and should not print money and hand it out. That is your job, even if that would be very stimulative.

Independent agencies should also, as much as possible, implement laws and rules. The more an agency operates with wide discretion and sweeping powers, the more it must be supervised by the imperfect but accountable political process. So your hard task in these bills and beyond is to rethink the limits, rules, and consequent independence versus accountability of the Federal Reserve.

Now, conventional monetary policy consists of setting short-term interest rates, looking at inflation and unemployment. But the Federal Reserve has taken on a wide range of new powers and responsibilities and more are being contemplated. I encourage you to look beyond conventional monetary policy and consider these newly expanded activities as these bills begin to do.

Interest rate policy now goes beyond inflation and unemployment. For example, should the Fed raise interest rates to offset perceived bubbles in stock, bond, or home prices, or to move exchange rates? I think not, but I come to stress the question, not to offer my answers.

A rule implies a list of things that the Fed should not respond to, should not try to control, and for which you will not blame the Fed in the event of trouble. A rule based on inflation and unemployment says implicitly, "Don't manipulate stock prices." This may be a useful interpretation for you to emphasize in the future.

But the Fed now goes beyond setting short-term interest rates. To address the financial crisis in the deep recession, the Fed bought long-term treasuries, mortgage-backed securities, commercial paper, in order to raise their prices directly. Well, should the Fed continue to try to directly manipulate asset prices? If so, under what rules or with what supervision and consequent loss of independence?

Since 2008, the Fed's regulatory role has expanded enormously as well. Two small examples: The Fed invented the stress tests in the financial crisis, and these have now become a ritual. The Fed makes up new scenarios to test banks each time. The Fed exercises enhanced supervision of these systemically designated banks, exchanges, and insurance companies. Dozens of Fed staff live full-time at these institutions, reviewing the details of their operations.

Now, these powers follow very few rules. They involve great discretion and little reporting or supervision from you, and billions and billions of dollars hang on the results. The Fed now contemplates macroprudential policy, combining regulatory and monetary policy tools and objectives. The Fed will vary capital ratios, loan-to-value ratios, or other regulatory tools over time, along with interest rates, if it sees bubbles or imbalances or in order to stimulate.

Well, the Fed's bubble is the homebuilders' boom, and the builders will be calling you if the Fed decides to restrict credit. Do you want the Fed to follow these policies? And if so, with what kind of rules, what kind of limits, and what accountability?

The bill's requirements for stress-test transparency, language simplicity, and cost-benefit analysis, I think, are an important step in managing this regulatory explosion. The bill's authorization for the Fed to exempt all persons from even congressionally mandated rules, which prove unwise, is, I think, a landmark. But beware that filling out mountains of paper won't mechanically improve the process.

These are just a few examples. The Federal Reserve's scope and powers have expanded dramatically since the financial crisis, and as they always do when there is extraordinary events. New powers and policies always involve great experimentation and discretion. Now is the time to reconsider the limits, rules, mandates, goals, and accountability for all these new policies. And these bills are an important first step.

[The prepared statement of Dr. Cochrane can be found on page 42 of the appendix.]

Chairman HUIZENGA. Thank you, Dr. Cochrane.

And, with that, we will recognize Dr. Kohn for 5 minutes for your opening statement.

STATEMENT OF DONALD KOHN, SENIOR FELLOW, ECONOMIC STUDIES PROGRAM, BROOKINGS INSTITUTION

Mr. KOHN. Thank you, Mr. Chairman.

No institution is perfect. Circumstances change. Lessons are learned. All policy institutions must adapt if they are to continue to serve the public interest. In my view, however, many of 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 they could harm it.

Being as systemic, predictable, and transparent as possible about what the Federal Reserve is doing in monetary policy increases the effectiveness of policy because it helps private market participants accurately anticipate Federal Reserve actions. It enhances your ability to assess the policy's strategies of the FOMC. But the key phrase in that sentence was "as possible."

The U.S. economy is complex and ever-changing, and cannot be comprehensibly summarized in a few variables and empirical relationships. Requiring the Fed to send you a rule would be at best a useless exercise and could prove counterproductive. If it is adhered to, it will produce inferior results. If not, as I would hope and expect, it would be misleading. In the latter case, the GAO would be frequently second-guessing the FOMC's decisions. Indeed, under another section of the legislation, the exemption for monetary policy from GAO audit would be repealed.

In my view, Congress was wise to differentiate monetary policy from other functions of the Federal Reserve in 1978 when it authorized GAO audits. It recognized that the GAO audits could become an avenue for bringing political pressure on the FOMC's decisions. It recognized that, over time and across countries, experience suggested that when monetary policy is subject to short-term political pressures, outcomes are inferior; inflation tends to be higher and more variable. In that context, the extra pressure of GAO audits moves the needle in the wrong direction.

Supplying liquidity to financial institutions by lending against possibly illiquid collateral is a key function of central banks. When confidence in financial institutions erodes and uncertainty about whether they can repay the funds they borrowed increases, they experience runs. Without a back-up source of funding, lenders are forced to stop making loans and to sell assets in the market at any price. That harms the abilities of households and businesses to borrow and spend.

Borrowing from a central bank under such circumstances helps lenders continue to meet the credit needs of households and businesses. It is an essential way for the central bank to cushion Main

Street from the loss of confidence in the financial sector. For most of the 20th Century, the Fed could do that by lending to commercial banks and other depositories. But in 2008, the Fed found that lending to nonbanks—investment banks, money market funds, buyers of securitizations—was required to stem the panic and limit the damage to Main Street.

The Fed supported giving the FDIC an alternative method of dealing with troubled financial institutions and limiting the use of discount window for nonbanks, the facilities that would be widely available to institutions caught up in the panic. Congress made those changes on lending to nonbanks in the Dodd-Frank Act. In my view, going further would limit the effectiveness of the Fed's lender of last resort function for a 21st Century financial market and raise the risk to households and businesses.

The Fed has been adapting its monetary policy strategy and communications. The Fed, other regulators, and Congress have addressed many of the deficiencies in regulation and supervision that allowed the circumstances that led to the crisis to build. So I don't think there are major changes that need to be made in the Fed, but I cannot rule out that a group of thoughtful policy experts might be able to suggest some further improvements to goals, structures, and decision-making processes.

But the proposal before us has a panel rooted in partisan politics, not expertise, and its makeup is strongly tilted to one side. It has, in effect, prejudged 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, 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.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Kohn can be found on page 47 of the appendix.]

Chairman HUIZENGA. Thank you for your testimony.

And last, but certainly not least, we have Dr. Paul Kupiec from the American Enterprise Institute.

And, sir, you are recognized for 5 minutes as well.

STATEMENT OF PAUL H. KUPIEC, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. KUPIEC. Chairman Huizenga, Ranking Member Moore, and distinguished members of the subcommittee, thank you for holding today's hearing and for inviting me to testify.

My oral remarks will summarize my written testimony and discuss some additional issues related to these proposals.

Today's Federal Reserve would not be recognized by its 1913 founding fathers. Congress has amended the Federal Reserve powers and responsibilities many times in the Fed's 100-year history. For the most part, Fed changes have been triggered by unfavorable economic developments: the Depression in the 1930s; post-war inflation in the 1950s; stagflation in the 1970s; and most recently, the housing bubble and financial crisis. The financial crisis forced the Fed to reinvent its approach to monetary policy. And even with massive Fed stimulus, the recovery is among the weakest on record.

Congress has Federal Reserve oversight responsibility, and from time to time, that duty may require a reexamination of the mandate powers and functions of the Federal Reserve System. The Centennial Monetary Commission Act of 2015 is a mechanism for exercising congressional oversight. The bipartisan commission would assemble experts to analyze the Fed and report recommendations for legislative changes to modernize and improve Federal Reserve operations.

This proposal would be even better if the commission's scope were expanded to examine the Federal Reserve's regulatory function. The commission should have sufficient time to complete a thorough analysis and formulate its representations. Unrealistic deadlines increase the risk of a rush to premature conclusions.

Should this bill pass, I can predict with near certainty that the Fed will be eager to loan the commission its large and talented staff. Lead this horse outside the city gates.

The Federal Reserve Act, the second bill discussed today, includes 13 sections. Many are simple, common-sense updates. Among the controversial parts, Section 2 requires the FOMC to publicly disclose its directive policy rule for monetary policy, compare it to a specific reference policy rule, and inform the Congress when its monetary policy differs from the Fed's directive policy rule and explain why.

Basically, the FOMC must provide the Congress and the public with a transparent statement of the methodology the Fed uses to short-run monetary policy. The proposal puts no restriction on the Fed's monetary policy rule, and the Fed may change its rule at any time. Disclosure of a reference monetary policy will enhance the quality of the policy debate. Differences between the policy prescribed by the reference rule and the Fed's chosen policy rule will undoubtedly generate lively discussion and the Fed will be required to defend its policy actions to the Congress and to the public. This will significantly improve Fed oversight.

Section 4 of the Act changes FOMC voting so that the Federal Reserve Bank presidents all have an equal say on monetary policy. That is a welcome change. The change at voting may impact the FOMC's vice chairman selection, but I did not see that issue addressed in the current proposal.

Section 5 requires the Federal Reserve Board to disclose the model it uses to estimate CCAR stress test losses. Greater transparency is badly needed. The disclosure should apply to all asset classes modeled in the stress test.

Section 8 requires the Fed to conduct cost-benefit analysis before it issues a new regulation and undertake a follow-up study to verify that the regulation is working as planned. This proposal fills a big loophole in existing regulatory law. Perhaps language could be added on compliance mechanisms.

Section 10 of the Act requires the Federal Reserve Board, the FDIC, and the U.S. Treasury to notify the public and the Congress when these agency staff enter into negotiations, consultations, or agreements with international standard-setting bodies like the Financial Stability Board (FSB). This timely requirement should be expanded to include the SEC and the CFTC.

Section 11 would amend the Federal Reserve Section 13-3, special lending powers. The proposals would reform Section 13-3 lending powers given in the Dodd-Frank Act to prevent the Fed from lending to an individual distressed and potentially insolvent financial firm to keep it from failing in the next financial crisis. The language in this proposal should apply to any Federal Reserve lending and not just to the Federal Reserve Board.

Thank you, and I look forward to your questions.

[The prepared statement of Dr. Kupiec can be found on page 52 of the appendix.]

Chairman HUIZENGA. Thank you for that.

And at this time, I will recognize myself for 5 minutes for questioning.

Dr. Kupiec, you just got done talking about this.

Dr. Taylor, I know that you have talked about this as well. And it is oftentimes referred to as the Taylor Rule. We have heard gold-structured policy, reference-based strategies. I had suggested when Chair Yellen was here that she could change it however she wanted, and we will dub it the Yellen Rule of how to move forward. I think that was a pretty good idea, by the way.

What exactly do you view this, as far as support within the Federal Reserve System, the notion of having this strategy-based approach or rule-based strategy, however you want to title that? As I pointed out to Chair Yellen, she had expressed support for a rules-based policy. Dr. Charles Plosser has gone pretty extensively on that. So just give me a sense of where economists within the Fed System already have sympathy for that approach.

Mr. TAYLOR. I think, if you look over the longer span of time of monetary policy, you can see periods where a more rules-based strategic—whatever you want—policy has been at least correlated or associated with better economic performance. And one of the periods I mention frequently is the very beginning, early in the 1980s and 1990s and until recently. If you look at the period before that, it was quite chaotic, very ad hoc, with a lot of stop-go policy. And I think, since then, you see a lot of deviations from a strategy that worked.

There is also research with models or with just ideas that tends to show the same thing, an advantage to having a clear, laid-out, predictable strategy. Actually, Don Kohn mentioned some of those things. It gives the markets a sense of what is going on. It just works better all around, and it is actually not unusual. Many policies—

Chairman HUIZENGA. Let me expand on that a little bit, because we have seen markets respond rather forcefully at two FRC—FOMC meeting releases and press conferences. Does it suggest that guidance would be improved so it wouldn't be as volatile?

Mr. TAYLOR. Well, yes. I think if there are fewer surprises, there are fewer adverse reactions. There are fewer sharp movements in the market. There is always going to be an effort to predict or anticipate what a big player like the Fed will do. But to the extent that their strategy is there, it will be laid out and be less of a surprise.

Chairman HUIZENGA. Okay. And having the Fed clearly explain differences between actual policy choices and a standard reference strategy could increase the transparencies in this regard?

Mr. TAYLOR. I think so. I think, in a sense, they do that internally a lot anyway and have for years. So it would be bringing it out for other people to see and debate, I think, in a constructive way.

Chairman HUIZENGA. Dr. Cochrane, do we threaten the Fed's independence with what we are try to do here?

Mr. COCHRANE. I think you establish the Fed's independence. Independence comes with limited powers and a clear understanding of what Congress wants them to do and doesn't want them to do. So I think without a deal, we are in even more trouble. The Fed worries a lot about Congress looking over its shoulder. So I think by establishing a structure, a set of rules, what you expect from the Fed and what you want them to do, what you don't expect them to do, that is the kind of deal that allows them to exercise the needed independence on some things and limits them from going onto other things.

Chairman HUIZENGA. I have 1 minute left here. I want to move on to Section 13-3. In a recent speech, Federal Reserve Bank President Jeffrey Lacker argued that because it promotes creditor expectations of future bailouts, Section 13-3 is antithetical to the goal of achieving financial stability. And I will dispose of the reading of this whole quote here, but I am curious, how would you respond to President Lacker's suggestion that the Federal Reserve's Section 13-3 authorities undermine financial stability and that Dodd-Frank did not go nearly far enough in constraining those authorities? Dr. Cochrane or Dr. Kupiec, if you care to—

Mr. KUPIEC. I think Jeff is very thoughtful on these topics, and I think the changes that are proposed in this legislation would put tougher restrictions on Fed 13-3 lending. I think the danger is that the Fed wouldn't be able to do any lending under Section 13-3 ever, and I think this proposal does not go that far. It just puts more criteria on it, and in a reasonable way, such that the nine other presidents would have to agree that the special lending was appropriate.

I am a little unsure about who certifies that the firm is solvent. That part of the law I didn't quite see where the certification would come from, but it is very much a move in the direction of fixing the things that Jeff Lacker has pointed—the problems Jeff has pointed out.

Chairman HUIZENGA. Thank you.

And with that, my time has expired.

I recognize the gentlelady from Wisconsin for 5 minutes.

Ms. MOORE. Thank you so much, distinguished panel, for taking the time. We always learn a great deal through these hearings.

I guess, I want to start out with much trepidation with you, Dr. Taylor. God forbid that I should ever have to argue or debate the Taylor Rule or any other kind of rule with you. I was looking at Ben Bernanke's blog, and we had—the Federal funds rate is equal to the rate of the inflation plus half the percent deviation and real

GDP from a target, plus—and so on, and then times your Taylor Rule.

So I guess what I have heard you say here today is that you are not being as prescriptive as some of your critics have indicated that you have been. You have contended that today here in your testimony. But as I look at the criticism, specifically from Dr. Bernanke, who has some models and you probably have seen these papers—God forbid I would have to read your Taylor Rule myself—but he is indicating that the Fed, during the 2008 debacle, that they kept the funds rate close to zero, about as low as you can go.

And when he looked at the Taylor Rule model, it would have had to go, of course, below a zero rate. So they really couldn't follow your model. They had to look for other tools, like the purchasing of security, to further do monetary ease. So what Dr. Bernanke said essentially in his criticism, if I am reading it correctly, is that just simply using a construct like that would not have ultimately been a useful tool. They would have had to find some other model, other than the so-called Taylor Rule.

And then you go on to say that you want them to be independent, but then they should have a GAO report on monetary policy put together when they have to deviate from your strategy. Explain to us how a GAO report put together in 7 days would substitute for the actions of the Fed?

Mr. TAYLOR. So the first part of your question, regarding when a formula takes you below zero in the interest rate, it has been discussed for decades what would happen. And my proposal was then you would keep money growth constant, or you would leave it at zero or .125 for a while and keep money growth constant. It is pretty standard. We worked that out long ago. It doesn't mean you do all sorts of other things. There are other reasons to do that, quantitative easing, et cetera.

With respect to your question of the GAO, I understand the GAO would help determine whether the rule—or I should say the Fed's decision was changing from one period to another. So the Fed has an opportunity to describe a change in the strategy or in the rule. And the GAO would assist in determining whether there was a change or not. I think that is the way the legislation currently works. The GAO would come in and make an assessment of what has the Fed changed and perhaps as a result should be reporting the reason for the change.

Ms. MOORE. Thank you so much for that.

Dr. Kohn, let me ask you whether or not it is common for banks and traders to set up strategies and projections based on Fed policy and that, what would adoption of something like a Taylor strategy or rule construct—would that increase the dependency and create a situation where banks and traders will rely on these computer model assumptions, and what might be the impact of them following these constructs?

Mr. KOHN. Of course, all participants in financial markets try to anticipate what the Federal Reserve is doing. It is an important player in the market. It controls very short-term interest rates. So, yes, banks and other financial institutions and other investors base their decisions in part on expected monetary policy and how that interacts with the economy.

Giving them a rule to rely on would give them perhaps more certainty about what was going to happen or give them the perception that they would be more certain what was going to happen and have them pile into the investments on that basis. My concern would be that would not be justified. The economy changes. Things happen. The Fed would not be able to follow the rule. And so having markets count on something that wasn't going to happen, I think, could cause undue turmoil and volatility in markets.

Chairman HUIZENGA. The gentlelady's time has expired.

With that, the Chair recognizes the vice chairman of the subcommittee, Mr. Mulvaney of South Carolina, for 5 minutes.

Mr. MULVANEY. I thank the chairman.

Dr. Taylor, I don't know if you had a chance to watch Chair Yellen's presentation to the committee last week, but on several different occasions, folks asked her about a rules-based system. Sometimes they mentioned the Taylor Rule by name; other times they did not. Her response seemed to be fairly consistent.

On a couple of occasions, I recall her saying that she worried about the efficacy of a rule that had only two variables. I assume this is a slight intended at the Taylor Rule. If it is, it is a reservation that she didn't have when she recommended the Taylor Rule 20 years ago. But I thought I would give you the opportunity to respond to that apparent criticism of the Taylor Rule that it cannot be efficacious because it only has two variables.

Mr. TAYLOR. Actually, one of the most amazing things that people discovered years after that was proposed is that two variables were quite successful in explaining a lot of the good aspects of the decisions. I remember Chairman Greenspan talking about that way back when. But the truth is it can't explain everything with the two variables. Anybody would know that. And there are times when you have to deviate from it.

When I first wrote about this, I talked about the 1987 stock market crash and the Fed's intervention at that time. But that is an intervention or a deviation relative to this benchmark, relative to this strategy. It just doesn't throw everything out at the same time and make fresh decisions. It is relative to a strategy.

So I think focusing on the only two variables can be quite misleading. That is why I mentioned Ranking Member Moore's question to Janet Yellen about the Greek crisis. Would you have been able to react to the Greek crisis, Chair Yellen, with only these two variables? Well, no, there are only two variables. But I think that is not correct.

If the Fed had wanted to, we could debate whether or not that is appropriate or not anyway. It would have said we are going to do it for these reasons, just like it did in 1987. So I think that is to me a sensible way to make policy. You have a strategy. It basically works, whatever you want to say, 80 percent, 90 percent of the time, and you deviate from it in a clear, transparent way when you need to.

Mr. MULVANEY. Thank you, Dr. Taylor.

Gentlemen, I want to switch gears on you and talk about a new topic that just came up in the last 48 hours. It comes out of the Senate. I don't know if you followed it this morning or not. The Senate has a proposal on its transportation bill, a pay-for on the transportation bill that would change the dividend that Fed member banks receive on essentially the stock that they hold. They are required, I think, to keep 6 percent of their capital at the Treasury. They are not allowed to earn reserve on that. It is essentially their shareholdings in the Fed.

And the Senate proposal is to lower the statutory dividend on that amount of money, on that capital, on that reserve, from 6 percent to a point-and-a-half. I have no idea what that has to do with transportation, but then, again, I don't pretend to understand everything about the Senate anyway. I would be curious to know— if anybody wants to chime in on whether or not you think this is a good idea? A bad idea? Is it the type of thing that maybe we should look at before we throw it in as a pay-for for a Senate bill we will probably vote on in the next couple of days up here? Does anybody have an opinion on that? Dr. Kupiec?

Mr. KUPIEC. Yes, the 6-percent yield on Federal Reserve stock is a feature of the original Act. And so the stock pays a 6-percent dividend and it doesn't matter what the earnings of the system are. Some bankers have joked with me in the past that their best earning asset through the crisis has been their Federal Reserve stock at 6 percent when every other rate is near zero.

And so adjusting the rate does not seem out of line, considering the rates that any of us can earn on our savings. The banks, of course, would not be very happy about it because their revenue would be less. The Federal Reserve would have, in a sense, higher operating earnings and return more to the Treasury at the end of the year, so that is the sense at which it would help pay for transportation.

Mr. MULVANEY. Is there a reason we set a dividend by statute? I am not aware of that happening in many other places.

Mr. KOHN. I think it was set as part of establishing the Federal Reserve Act, and it was because they wanted banks to join the Federal Reserve, and they recognized that forcing them to buy equity, and equity that wasn't tradeable, wasn't salable, couldn't be used explicitly, couldn't be used as collateral for anything. So you have an asset that is basically frozen and you can't do anything with it. And if you didn't earn anything on it, that is equivalent to a tax. So, basically, you are holding this asset instead of making a loan to a household or a business.

Mr. MULVANEY. Is there any advantage—

Mr. KOHN. And the 6 percent was to compensate and offset, in effect, the tax on banks.

Mr. MULVANEY. Instead of setting a statutory rate, is there any advantage to allowing it to float with the market? What is the justification for paying somebody 6 percent right now when markets are paying—

Mr. KOHN. It is not really an asset like other assets, so I wouldn't know how to set it. I am not sure 6 percent is the right rate, but let's recognize that by lowering it to, say, 1.5 percent on the proposal, in effect, you are placing a tax on banks over $1 billion.

Mr. MULVANEY. Thank you, gentlemen.

Chairman HUIZENGA. The gentleman's time has expired.

The Chair recognizes Mr. Foster of Illinois for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman.

We are living through the aftermath of a disaster caused by the complete failure of Republican monetary, fiscal, and regulatory policy.

You guys have been around business schools a lot. And so I was wondering, normally if you had a disaster and then you appoint a commission to make recommendations as to how to prevent that disaster from recurring, would you normally have a majority in that commission from the group that caused the disaster or the group that fixed the disaster?

I will just go down the line. If anyone—let's just raise hands. Who believes that those who fix the disaster should hold the majority on the committee?

Mr. COCHRANE. I will take it. As an academic, I think there is enough blame to go around of both parties, Wall Street, and everybody in the debacle. And as academics, I think we would say make the commission all academics, and then we will give you the right answer.

Mr. KOHN. I do think I agree with Dr. Cochrane's first comment; there is enough blame to go around. I would prefer a bipartisan or, frankly, a nonpartisan group of experts.

Mr. FOSTER. Right. As opposed to one where there is two to one the majority party as is being proposed.

But I am a little bit confused actually by your statement that there is enough blame to go around, that this was an act of God. Which party had control of monetary, fiscal, and regulatory policy in the years preceding the crisis? Was there equal control of monetary, fiscal, and regulatory policy in those years?

Mr. COCHRANE. I have written about sources of the crisis. And if you look at the structure of the financial system and financial regulation that fell apart, it goes back hundreds of years. It goes back to the structures set up in the New Deal. So both parties constructed this thing, and it fell apart.

Mr. FOSTER. Okay. Let's just return to monetary policy, which is the main subject here. I think that most people would agree that the greatest sin of the Fed in terms of monetary policy, and certainly in the last few decades, has been the decision to maintain very accommodative monetary policy and help inflate the housing bubble in the 2003 to 2004 time scale.

And so there is by necessity, on these proposals, a get-out-of-jail-free card for the Fed to say: Well, you know, we have this rule, but this is a special case this time.

And so what in that would have prevented Alan Greenspan and the Republicans' appointees of that time from simply having said, "Oh, I am sorry, it is 2002, 2003," or, play the 9/11 card, whatever they have done, and simply done what they did and inflated the housing bubble, which, of course, has driven most of the pain that we are having a long time recovering from?

Mr. TAYLOR. So the 2003, 2004, 2005 period I have written about, written books about, I think it was, as you say, an effort that resulted in excesses and housing bubble. It ultimately was a factor in the severity of the Great Recession.

Mr. FOSTER. Unquestionably.

Mr. TAYLOR. There is no question, in my view.

That is, in fact, why I think this legislation is potentially so important, because that period is when there was a clear deviation from a strategy, like I have been advocating, like a strategy that worked in the 1980s and 1990s.

I don't think it is fruitful to talk about Republicans and Democrats in this context. The important thing is to get going and fix this problem. And you can look over the last 50 years and you can see a Republican Administration imposing wage and price controls on this entire economy. And you can see Democratic Administrations which didn't do the best either. The important thing is to look forward. And I think a commission, however you constitute it, is a way to look forward.

Mr. FOSTER. Dr. Kohn?

Mr. KOHN. As one of the policymakers at that time and an appointee of President Bush to be sure, I disagree with John. He and I have had this discussion many times. I don't think that the monetary policy of the mid-2000s was the major reason for the housing bubble. I think it was the private sector and the public sector both being too complacent about what was going on, too much reliance on the private sector to make these decisions, not enough oversight by the public sector, failure by the credit rating agencies. I think this was a regulatory failure, not a monetary policy failure. And a good deal of those failures have already been addressed in Dodd-Frank.

Mr. FOSTER. Okay. And I am guessing, there is a lot of emphasis in the discussion here about more transparency for stress tests. It seems to me that if you publish the stress tests, the stress factors that banks will be subject to, they will simply hedge out that specific set of risks, and it will be completely meaningless. Is there any reason to believe they wouldn't do that?

Mr. KUPIEC. Well—

Chairman HUIZENGA. Very quickly, gentlemen.

Mr. KUPIEC. —if they actually did hedge out the risk, that would be fine. They would be protected. So that wouldn't be a problem.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the Chair recognizes the gentleman from North Carolina, Mr. Pittenger, for 5 minutes.

Mr. PITTENGER. Thank you, Mr. Chairman.

And I thank each of you for being with us today.

As I assess our current status, we are at a very anemic economic growth by any standard. We have unemployment and real unemployment. Some estimates come in that 12 percent are considered to be underemployed and those who have quit looking.

What role do you believe the monetary policy is playing? The demographic group who has suffered the worst has been the low-income minority people in this country, yet we know the rulemaking has an impact on regulatory taxes and on consumers, on investors, including low-income and middle-income people.

Do you believe that a statutory economic analysis would be helpful to help mitigate this problem in assessing the role this has had?

Dr. Cochrane, we will start with you.

Mr. COCHRANE. I think it is important to recognize the limits of monetary policy, which is in part why it can and should be an independent agency. Monetary policy is like oil in the car: If there is not enough, the car stops. But once the car is going, pouring more oil in doesn't do any good. There are limits to what monetary policy can do.

Like everyone else here, I am disappointed at the slow growth rate of the U.S. economy. I am disappointed by how few Americans are working. But I think we all agree that is not something primarily that monetary policy can help with, and we need to recognize those limits.

Mr. PITTENGER. Dr. Taylor?

Mr. TAYLOR. I think the slow growth is largely due to policies, but I would add regulatory policy. I would add issues about budgetary uncertainty. And to the extent that monetary policy can be a drag, it can, especially if you include the regulatory parts of it. So I wouldn't exclude that.

Over time, there tends to be a relationship between, I guess, the interventionist discretionary approach in monetary policy and some of these other policies. So I think it goes hand in hand. I think kind of a restoration of a clear strategy for monetary policy would be beneficial all around.

Mr. PITTENGER. Dr. Kupiec?

Mr. KUPIEC. I think the regulations that have been imposed since the crisis are in large part causing slow growth. I think the issues today about monetary policy, this really isn't about requiring the Fed to change monetary policy; it is really about a disclosure of what their monetary policy is in a way that facilitates a discussion.

So I don't think that the questions about would the Fed react differently at this time or that time when Mr. Greenspan was in there, this bill is not intended to make them react in any particular way. They can write the rule however they want and react however they want. They just have to explain it clearly so the public and the Congress can understand what they are doing and then understand if they want to comment on it or offer opinions on it, whether it is appropriate or not.

So I will stop there.

Mr. PITTENGER. Dr. Kohn?

Mr. KOHN. In my view, the unemployment rate would be higher. More people would be unemployed if the Federal Reserve hadn't engaged in the aggressive and unconventional policies that they did. If they had followed the Taylor Rule and interest rates were a couple of points higher, the stock market would be lower, the dollar would be stronger, the cost of the capital would be higher, demand would be even weaker. So I think the Fed can take some credit for the progress that we have made. The underlying problem is productivity growth, and this is a global problem.

Mr. PITTENGER. Thank you.

Dr. Cochrane, help me understand the benefit of the cost-benefit analysis and what we can achieve through that.

Mr. COCHRANE. I don't want to—regulations should think about that this language in the bill is pretty clear. Do they actually do what they are supposed to do, and do they impose costs greater than in benefits? So the regulation should do that. Now—

Mr. PITTENGER. Is there a downside to that? Is there any—

Mr. COCHRANE. Absolutely. The downside to that is potentially just filling up mountains of paperwork because we all know how easy it is to get numbers to come out the way they want to. But at least thinking about the question and having to come up with a, "here are what we think the costs are, here are what we think the benefits are," that seems like an important structure for regulation.

And an important part of this bill is if the Fed—even if the Dodd-Frank Act has put in a regulation, if the Fed says, "Look, we have looked at it, it is not going to work," the cost is greater than the regulation, then they don't have to do it. That is an important escape hatch.

Mr. PITTENGER. Thank you.

I yield back.

Chairman HUIZENGA. The gentleman yields back.

With that, the Chair recognizes the gentleman from Connecticut, Mr. Himes, for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman.

I am still trying to figure out what problem exactly it is we are trying to solve here, particularly given the general consensus that independent monetary authority independent of political meddling is so important. I am trying to see what the problem is. I hear, as I always do from the other side, that the economic recovery hasn't been fast enough.

My time here has corresponded, of course, with the depth of the meltdown and the recovery. And, of course, 6 years ago, we were treated to the—everything was job-killing. Everything. The ACA, the Dodd-Frank, fiscal monetary policy was going to kill jobs. That, of course, is a little harder argument to make in the face of 12 million jobs created and the unemployment rate down around where it was pre-crisis.

So now we hear something that, frankly, I think is junk science and junk economics, that it could have been better. This from an institution that thought the sequester was a good idea, that thought that an 18-day government shutdown was a good idea, that thought that threatening default on U.S. sovereign obligations was a good idea.

So I guess my question, just to start here, outside of this room, most people acknowledge that proposals to "audit the Fed" will over time chip away at its independence. And you just read the proposal where the GAO is authorized to audit the conduct, not the numbers but the conduct of monetary policy, that any committee requested by the House Financial Services Committee or the Senate Banking Committee can haul the Chair of the Federal Reserve in front of us to testify for 7 days. That sounds like it points in the direction of meddling.

So I guess I have a couple of questions for the panel: One, does anybody really want to make an argument—Dr. Kupiec, you said that the economy has not recovered—does anybody really want to make an argument that the conduct of the Fed's monetary policy has been a material drag on the recovery since 2008?

Mr. KUPIEC. Congressman, I don't think this bill is about that. I think this bill is about the oversight responsibilities of the Congress. The Congress—

Mr. HIMES. No, no. I am asking a very specific question. I have read the bill. My question is, does anybody want to make an argument that the FOMC contributed materially to a slower recovery than otherwise might have occurred? That is my question.

Okay. Nobody here is saying that the FOMC or monetary policy actually slowed the recovery. Dr. Taylor?

Mr. TAYLOR. I think you have to look at the period of the recovery and the period before the crisis. We just got through saying that the policy, in my view, and I am not the only one, felt that those excessively low rates compared to the 1980s and 1990s were part of the problem, and, therefore, part of the—so please admit, that is part of the issue we are trying to address. That is a big part for me.

I think the post-panic part, there is a real question about what the contribution of monetary policy was. And Don Kohn mentions low interest rates were simulative. I see all the uncertainty and the fears of the taper and all those things as a drag. So we don't know, but I feel it has been a drag.

Mr. HIMES. And actually, you and Dr. Kohn had an interesting back and forth. This is an ongoing debate, but let's frame this in longer term, let's think about what Paul Volcker did in the early 1980s, where he cranked up interest rates, crushed inflation, something, by the way, I would suggest would have absolutely gotten him dragged in front of the committees of this Congress and may not have happened, and as a result, we actually got a period of prosperity for which Ronald Reagan was able to take credit, because of some, frankly, very courageous and very difficult actions that Paul Volcker took.

So, two questions. First, do you really think that under the mechanisms of GAO audits and our right to call a Federal Reserve Chair in front of us under those circumstances, is there a possibility that Paul Volcker might not have been able to take those actions in the early 1980s?

And second, a larger question, looking back over the last 50 years, is the current operation of the FOMC, and let me just—Robert Samuelson sort of talked about all the checks on the FOMC, policy statements after FOMC meetings, 4 times a year, FOMC members release their economic forecasts, including predictions of interest rates, minutes of FOMC meetings providing more details, and then reviews are published soon after the meeting, the Fed's Chair conducts fewer news conferences a year.

Is that really not enough? Is there compelling evidence that there really should be more transparency and possible political injection into that process?

Mr. TAYLOR. So Paul Volcker, his contribution, which was tremendous to the economy, really took the Fed from a very really chaotic, un-rules-like policy in the 1970s, and kind of restored a more systematic policy, and that Chairman Greenspan took on a lot for a long time.

With respect to the data on transparency, yes, those are all positive, but I would add the inflation target to that. But in the meantime, when Mr. Volcker was Chair, the Fed was required to report its money growth, forecast for the year ahead. That was removed in the year 2000.

Again, as I said before, in some sense, this legislation really just puts something like that—puts that back in but in a more modern context.

Mr. Volcker used that in describing his policy change. It was useful to him. It didn't take away his independence. He restored independence to the Federal Reserve.

Mr. HIMES. Thank you.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the Chair recognizes the gentleman from Arizona, Mr. Schweikert, for 5 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. Have you ever had that moment you are so engrossed with both the conversation and the attempt to try to turn it into a partisan one, that you sit there and try to understand why? This is an interesting conversation of what ultimately produces stability and economic growth.

Dr. Taylor, first, just because it is a question I have wanted to ask, why not a peg, almost the Milton Freidman-type articles from the 1970s of create a peg and let the public markets also know what monetary growth would be?

Mr. TAYLOR. Milton Freidman, as you say, proposed a constant growth rate rule for the money supply. And what happened over time, I believe, is the money growth statistics became harder to assess. And in a way, things like these interest rate rules were a replacement for that, so things that Milton Freidman and I discussed many, many times. So it is kind of a replacement for something that I think reflected more modern times. And as I say, things like that worked pretty well. It is not always—you don't always have to use—

Mr. SCHWEIKERT. So in a modern time, as the legislation is written is at least telegraphing policy, does that telegraph the message to ultimately markets in the world and accomplish some of that same goal?

Mr. TAYLOR. Yes, I believe it does. The purpose is very much the same. And if you could do it with the money growth thing in a simple way, it would probably be better, but we found that is difficult.

Mr. SCHWEIKERT. Dr. Kohn, I actually had one, and I want to make sure I am not adding something in a previous statement you had, but I wanted to try to touch on sort of the mechanics of—the regulatory mechanics versus a rules mechanics, and when those policies ultimately clash. You had sort of—you touched on that. I wanted to see if there was more meat there.

Mr. KOHN. I am not sure I follow the questions about the rules clashing for the regulatory mechanics. My concern is that the rules will not really be useful for monetary policy, and that John Taylor made a useful distinction between strategy and rules in his statement. And I think the Fed has a strategy, and it has stated a strategy, and Chair Yellen and other members of the committee have talked about what they are looking at—

Mr. SCHWEIKERT. But that—

Mr. KOHN. —and that is different from a rule. And your proposal asked for models of the interactive relationship—a function that comprehensively models the interactive relationship between intermediate policy variables and the coefficients of a directed policy rule. So that is a rule and—

Mr. SCHWEIKERT. But it is a rule with the level of flexibility that they—from my reading of the legislation, that they could come back and adjust to it.

Mr. KOHN. Yes, but I think they do that every time. And I—

Mr. SCHWEIKERT. But Dr. Kohn, if they do that already, then you don't mind this legislation?

Mr. KOHN. Oh, I do mind it, because it creates a presumption and it, I think—as I said, at best, it would be useless.

So the money rules that John was talking about from September 1982 didn't have much effect on monetary policy, and so it was a discretionary policy from the end of 1982.

Mr. SCHWEIKERT. I think we are talking around each other.

Dr. Cochrane?

Mr. COCHRANE. You mentioned regulation, which may be where the question is going. And I think bringing the Fed's regulatory activities under the same roof is important, and this goes to the previous comments about independence.

Beyond what they do with interest rates, the Fed buys securities; the Fed tells banks to raise their loan-to-value ratios because they are worried about a bubble; the Fed comes up with a stress test that has various results. Do you want the Fed to make these actions, which have macroeconomic as well as regulatory impacts, with complete impunity? Do you want them to make them up as they go along, or do you want to them to state a strategy, and communicate those the same way they are stating a strategy for—

Mr. SCHWEIKERT. But Dr. Cochrane, in that particular scenario, how often am I—am I ever going to run into a situation where the rules that I am expecting my regulated entities, my credential regulation, to engage in, will they ever conflict with what the Fed is actually doing? We want you to abide—be making sure you are holding this type of capital or that your buckets are full of this, while they are actually engaging in other activities. Is it almost too much concentration on both sides of the see-saw, where we are doing monetary policy here and regulatory policy over here?

Mr. COCHRANE. I think you have to think about them as a unified thing. The Fed uses regulatory policy, it uses asset purchases as part of its direction of the macro economy.

Mr. SCHWEIKERT. Dr. Taylor?

Chairman HUIZENGA. The gentleman's time has expired.

Mr. SCHWEIKERT. Oh, I'm sorry. I yield back.

Chairman HUIZENGA. With that, the Chair recognizes the gentleman from Delaware, Mr. Carney, for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman. And thank you to the panelists today. It is an interesting, if a little confusing conversation for a non-economist over here, and a non-nuclear Ph.D. scientist, as we have on our side.

So we have two bills before us, and there seems to be interest, obviously, in—it is always helpful from time to time to put together a bipartisan commission that would look at how we are operating. But I have heard everybody say that this should be nonpartisan. I see people shaking their heads. This bill would require that 8 of the 12 members be Republicans, effectively, because they would be appointed by the Speaker and by the Majority Leader in the Senate. Does that sound like a good idea, a nonpartisan idea, Dr. Cochrane?

Mr. COCHRANE. I would just like to answer that we are economists, and you are politicians, a noble profession, and you shouldn't ask us for political advice about how to put together a commission.

Mr. CARNEY. Well, you—

Mr. COCHRANE. Re-thinking these issues is important, and maybe you need more Republicans to get it through a Republican Congress.

Mr. CARNEY. A minute ago, you said that it should be nonpartisan. That sounded like a political comment to me.

Mr. COCHRANE. These are nonpartisan issues.

Mr. CARNEY. Would you admit that having a commission with eight members who are Republicans and four members who are Democrats is stacked one way or the other? You don't have to be an economist to figure that out, right?

Mr. COCHRANE. What I just want to—these are nonpartisan issues, these are issues that are important to the country as a whole, and that you find people lining up on in ways unrelated their party affiliations.

Mr. CARNEY. So it would be better if it was more balanced?

Let's go to the—let's go—

Mr. COCHRANE. Other—

Mr. CARNEY. Let's go to the second piece of legislation, since everybody else is frowning and doesn't want to really touch that, but that is troubling to me. I think having a commission that has balanced representation may make some sense.

So the rule-based approach, Dr. Taylor, and thanks for coming, you have come back, you have provided great expertise to the committee, I think the question really is, you have admitted yourself, and Dr. Kohn has said that the Fed uses a strategy, and you, yourself, have said that they ought to use a rule, and they probably do, but they shouldn't apply it all the time, they ought to deviate from it from time to time. Is that what you said?

Mr. TAYLOR. Yes. I do—there is an issue about strategy. The Federal Reserve has a statement about goals and strategy. If you look—and it is mostly goals. I can't really see a strategy there. It basically says what they want to achieve. But for me, a strategy is what you are going to do, what you think you are going to do with your instruments that you have—

Mr. CARNEY. Right.

Mr. TAYLOR. —the tools that you have, but it is not there.

Mr. CARNEY. So this mechanism would establish that, oh, on pages 3 through 6 or 7, a pretty rigid approach and then require the Fed to report back on whether they are deviating from that pretty rigid approach. Am I reading it correctly there? You mentioned flexibility, that they are not required to use this, but it sounds—it feels pretty tight to me.

Mr. TAYLOR. A lot of people don't think it is tight enough. I think it has a balance. Again, the idea here is the Fed chooses the strategy. The Congress is not micromanaging. The Fed is—the oversight is on its strategy. The Fed chooses it, the Fed can change it, the Fed can deviate from it as long as it reports the reasons why.

Mr. CARNEY. Right.

Mr. TAYLOR. It seems to me to be minimal in terms of oversight that you would want to exercise.

Mr. CARNEY. They do that to an extent right now under the requirements to report to us and before the committee under Humphrey-Hawkins. Is that not adequate, the dual mandate of inflation and employment? You obviously would want them to report on something relative to this pretty hard-and-fast rule, which is what the bill would require.

Mr. TAYLOR. The bill has this reference rule in it so that the Fed would compare its strategy to this reference rule. And I don't think that is a burden, because the Fed already does—they already have these reference rules. They have a lot of them, as far as I know, although you can only look at it later.

I was surprised, for example, during the financial crisis, Don Kohn came to a meeting we had out at Stanford, and out of that discussion came the idea that one of their rules that interest rates should be minus 6 percent. I had never heard that before. I couldn't understand how they could get that. If this was external, we could have had a good debate on that and perhaps that would have been the outcome, but we don't know.

Mr. CARNEY. Yes. I guess the question really is, how can Congress best do its oversight role in this regard, right? I don't feel really equipped to be able to do that. I read the stuff, I pay attention, I listen to experts like you. We are given that responsibility, but it is a hard thing to do.

Thank you again, all of you, for coming.

Mr. TAYLOR. Let me just answer that. I think that is a very good point about ability to interact. In fact, one of the first responses to this proposal came from Don Kohn. He may not remember. He was saying that, well, the Congress just has to ask better questions.

Sorry, Don, but that is what you said.

And to some extent this legislation—

Mr. CARNEY. Exactly my point.

Mr. KOHN. I stand by my previous response.

Chairman HUIZENGA. And the Chair will remain mute on that issue, because his question time is done.

So with that, the Chair recognizes the gentleman from New Hampshire, Mr. Guinta, for hopefully 5 very good minutes of questioning.

Mr. GUINTA. Thank you very much, Mr. Chairman. As I indicated in my opening statement, I do believe that the first step to reform is transparency. I am not sure why we would be concerned about being transparent, why there would be an objection to being transparent.

Mr. Cochrane, we see the Fed continuing to expand its role in systemic regulation and credit allocation. Should we worry about its ability to produce sound monetary policy?

Mr. COCHRANE. Yes.

Mr. GUINTA. I would love for you to expand a little bit more on that.

Mr. COCHRANE. I think the monetary policy and regulation are becoming one, and this is kind of the trend going forward. International organizations are encouraging more of this macroprudential approach. It is also something that is natural to happen. I view monetary policy as actually much less effective than we all think it is, and yet we all want the Fed to do great things, so there is going to be more and more of a temptation for the Fed, if the interest rate lever isn't working a whole lot, well, let's just go tell the banks to do what we want to do, and they have that authority and they—and it is not really constrained by rules, by tradition, by reporting in the kind of transparency we have here.

So I think that is the big question for you and for the Federal Reserve. I think they are anxious for your guidance on how they should approach these questions.

Mr. GUINTA. Thank you. That brings me to my next point. Chair Yellen has recently repeated her strong objection, or opposition, to audit the Fed, and she has stated that she believes it will add political pressure on the central bank and potentially weaken the independence of the Federal Reserve. Again, I take a very, very different view. I don't agree with her assessment. I respect it. We have a difference of opinion. I think transparency, again, is something that the American people and the public want.

But I wanted to ask Mr. Kupiec this question: Would a full Fed audit, in your opinion, bring more transparency to not only the monetary process, but also the conflicts that these overlapping roles may be creating?

Mr. KUPIEC. I think this whole notion of a GAO audit of the Fed is very overblown. That is not really what this is about. GAO has the authority to audit everything about the Federal Reserve except for monetary policy. It is very explicit in the law. I assume when that law was passed, the Fed was the one that got that in the law, probably.

Now the only thing the GAO is going to do, if the Federal Reserve has to explain these two policies, is to look at the numbers and see if the Fed is doing what it says it is doing. Did they do the calculation right? Are they following the same rule? They are not second-guessing the rule. They are not really auditing—they are just telling the Congress so you guys don't have to get out your calculators and figure out if the rule actually says what the Fed's telling you. The GAO will do it for you. That is really all the GAO audit part of the second rule does, in my view.

Why the GAO was prohibited from having anything to do with monetary policy, I wasn't around in 1978, I think, when they did that, so I am not really sure, but the GAO's role here is really fairly minor. The audit is whatever Congress—you can create a study group and not involve the GAO and look at the monetary policy any time you want, according to the law.

Mr. GUINTA. Okay. I appreciate that.

Dr. Taylor, first of all, I think having the GAO do this would—if we don't want to be political or viewed as political—some would argue if Members of Congress were doing this, it would be political, so I think it would make it a reasonable argument to ask the GAO to do it, but, Dr. Taylor, I would like to get your thoughts on that.

Mr. TAYLOR. I would distinguish the role of the GAO in assessing whether or not the strategy has changed. I think that is part of the legislation. Someone has to do it. I don't really see the problem with that.

The full audit issue, I think you have to ask what would you get out of that, and maybe this is similar to Dr. Kupiec's answer, what would you get out of that compared to this legislation, which would actually be substantive: Here is what the Fed is supposed to be doing, here is what they said they are doing, if they don't do that, you can ask about it. A GAO audit doesn't bring you in that direction necessarily. So this, it seems to me, gets more at the transparency issue than the full audit would.

Mr. GUINTA. Okay. Thank you very much.

I yield back.

Chairman HUIZENGA. The gentleman yields back.

With that, the Chair recognizes the gentleman from Washington, Mr. Heck, for 5 minutes.

Mr. HECK. Thank you, Mr. Chairman.

Dr. Kohn, I kind of have this foundational belief that all legislative proposals ought to begin with a cogent problem statement, kind of subscribing to the political parallel of the Hippocratic Oath: First, do no harm. So while on the one hand, after 100 years, I am personally more than open to a discussion about how the Fed is organized. On the other hand, I am curious as to what you might think is a cogent problem statement for the specific proposal to strip the New York Fed from its permanent position of vice chair. It is not clear to me what that specific proposal problem statement is predicated upon, again, while being open to a discussion about organization. And as a part of that, especially given the New York Fed's particular role occasionally in interfacing with international counterparts, because they have so much responsibility for the implementation, I am curious as to whether or not you think it would cause a problem to strip the New York Fed from its role as vice chair. Yes, sir?

Mr. KOHN. I don't know what the problem is that is trying to be addressed. In my view, the New York Fed has a special role in the Federal Reserve System. It has been designated as the institution that carries out the directions of the Open Market Committee, it has quite a bit of expertise in markets, and carrying that out and analyzing markets. And I think there was a good reason for—I think, in 1940, for Congress to say the Federal Reserve Bank—the president of the Federal Reserve Bank of New York ought to be a Vice Chairman of the System. It is a bit of a special role, but it is not that special compared to other Reserve Bank presidents, but I think having that person able to vote and having that person—and recognizing that New York is the financial center of the United States, and one of the big global financial centers, benefits the Open Market Committee. So I don't know what problem that is trying to solve.

Mr. HECK. Are you concerned about any unintended consequences or problems, especially as it relates to their particular global role?

Mr. KOHN. I think it would be—there might be unintended consequences of undermining the voice of the New York Fed as it talks about implementing policy and how it is overseeing the markets on behalf of the Fed and the Treasury and the FSOC and others.

Mr. HECK. A follow-up on an unrelated question: H.R. 2912 seems to place emphasis on price stability over employment, if you translate out how the bill would actually work. In fact, if you did the math, I think you could actually come to a specific conclusion that its intent is to place a higher priority on price stability.

I have always kind of viewed price stability and employment as two ends of a teeter-totter. We are in this constant search for the right balance. There are times, however, that for whatever reason, business cycles, external factors beyond our control, one of the sides of that teeter-totter gets out of hand. Unfortunately, I am old enough to remember when we had to purge inflation out by charging 5 jillion percent interest rates.

Does it strike you that structurally placing a priority of one over the other really constrains the Fed's ability to respond situationally when it is the other side of the teeter-totter that has problems?

Mr. KOHN. I think most of the time, the two are in sync. Pursuing one will help pursue the other. And this is a very good example today of raising employment and boosting demand will help get inflation up to the 2 percent target.

I think, number two, the Federal Reserve has recognized in the statement that John Taylor talked about on its objectives that over the long run, it must keep its eye on that 2 percent inflation target. There are times, rare, but there are times when there are conflicts and you have to decide how rapidly to go back to your 2 percent inflation target, and taking account of what is happening to employment at the time is a helpful way of balancing those objectives in pursuit of the long-run objective of price stability.

Chairman HUIZENGA. The gentleman's time has expired.

The Chair recognizes the gentleman from Minnesota, Mr. Emmer, for 5 minutes.

Mr. EMMER. Thank you, Mr. Chairman, and thanks to the panel for all your time today.

As I indicated in my opening statement, I am supportive of the Chair's proposed reforms for the Federal Reserve. Requiring the Fed to articulate a "rules-based monetary policy" so the public can reasonably predict how the Fed might react to a given set of circumstances is an important reform advocated by a wide variety of experts. Requiring the Fed to articulate a rules-based approach will inject some predictability in the marketplace, and to some of us, that would seem to be a good thing. In fact, according to testimony presented today, "a predictable rules-based monetary policy is essential for good economic performance."

Dr. Cochrane, I think you testified that the Fed's discretionary monetary policy is, in fact, damaging. Is that correct?

Mr. COCHRANE. I think several of us echoed the view that by taking discretionary decisions, the Fed injects volatility to the financial markets, and you have seen financial markets sneeze on every decision.

To the extent that you are following a rule, there is just no surprise, because everyone knows what you are going to do ahead of time.

Mr. EMMER. Right. And one of the regular complaints we hear from families, entrepreneurs, and existing businesses is the uncertainty created by government actors with great independence and power that is not clearly limited.

Requiring the Federal Reserve to propose—again, this would support the proposed reform. Requiring the Federal Reserve to propose a cost-benefit analysis before adopting new rules is not only a good idea, but Dr. Kupiec, I think you testified that this proposed reform actually fills a loophole in existing regulatory law, is that right?

Mr. KUPIEC. Most Federal Government agencies, before they propose a rule, have to do a cost-benefit analysis. The financial agencies, regulatory agencies, have been exempt from that requirement, and typically haven't done formal cost-benefit analysis in the past. So the financial regulatory agencies are exceptional in that regard.

Mr. EMMER. And it seems to work well for them?

Mr. KUPIEC. It works well for them.

Mr. EMMER. With the time I have left, I want to go into a little different area. The Federal Reserve Act's mandate is to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

I hear the statement that unemployment in this country is down to pre-2008 levels all the time. In fact, I heard one of our friends on the other side of the aisle make a similar statement during his questioning earlier today. Now, the Chair of the Fed was before our full committee last week, and at that time Chair Yellen testified that, "Our economy has made progress towards the Fed's objective of maximum employment."

Frankly, this claim raises concerns for people like me and my constituents rather than answers questions or solves issues, especially since CNBC just reported only a few weeks ago that 8.5 million Americans still don't have jobs, and some 40 percent have given up even looking. According to the CNBC report, this revelation comes at a time when the labor force participation in this country remains near 37-year lows.

Chair Yellen testified further that other measures of job market health are also trending in the right direction, with noticeable declines over the past year in the number of people suffering long-term unemployment, and in the numbers working part-time who prefer to work full-time. She continued, "However, these measures, as well as the unemployment rate, continue to indicate that there is still some slack in the labor markets."

That seems to be a bit of an understatement, when our labor participation rate remains near 37-year lows. I question how my colleagues can suggest the Fed's monetary policy in the last 6 years has had a positive impact on our economy.

According to an article in the Investor's Business Daily last month, the overall growth in the 23 quarters of the Obama recovery has been 13.3 percent. That is less than half the average 26.7 percent growth rate achieved at this point in the previous 10 recoveries since World War II.

Sticking with Chair Yellen's testimony for a second, she also provided some testimony on the issue of the Fed's transparency and accountability. According to Chair Yellen, being transparent, the Fed is committed to being transparent and accountable.

Dr. Kupiec, do you agree that an audit of the Fed would help the Fed be more transparent and accountable?

Mr. KUPIEC. I think the policy proposal to require the Fed to explicitly state the rules that govern its policy on average and compare it to a reference rule would clear up many of these problems that you have just discussed. It would—they would have to specify exactly what unemployment rate they are targeting, it could be many of them, but they would have to be explicit about it, where they got about it, and you could have the discussion in an honest way.

As we all know, with statistics, it is really easy to make misleading claims when you have so many statistics to choose from. And the Fed has a very talented staff at crunching statistics, as we all know.

Mr. EMMER. Thank you.

Chairman HUIZENGA. The gentleman's time has expired.

For what purpose does the gentlelady seek recognition?

Ms. MOORE. I am just seeking recognition to put something into the record; I ask unanimous consent to place something in the record.

Chairman HUIZENGA. Without objection, it is so ordered.

Ms. MOORE. I would like to put something printed from the Brookings Institution, Ben Bernanke's blog, The Taylor Rule: The Benchmark for Monetary Policy. I referred to it in my testimony and would like it to be available.

Chairman HUIZENGA. Without objection, it is so ordered.

With that, the Chair recognizes the gentleman from New Mexico, Mr. Pearce, for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

Following along with the gentleman from Arizona's comments, I have been fascinated by the attempt to make a partisan statement out of this, the problems that we faced. Given that line of reasoning, it would be—you would come to the conclusion that President Obama will have no downstream responsibility for the deal he is working with Iran; that instead, it is everyone beyond that who is in office at the time that the problems will arise who bear the brunt of the blame, according to a couple of our friends on the other side of the aisle. I found that to be amusing and disingenuous to say the least. Because when I look at the problem, trying to explain it to people in New Mexico, basically you had people loaning money to folks who really couldn't pay for the houses they were getting, and eventually the house of cards collapsed.

Now, it wasn't the only problem, but definitely a key part of this was the ability to get rid of those loans so that you didn't have them when the music stopped, and the GSE's, Fannie and Freddie, played a significant impact in that. And James A. Johnson, who was the head of Fannie starting in 1991, that was under President Clinton, began to accelerate that process, and Franklin Raines, who continued, was nominated and came into power under—for Fannie during President Clinton's terms, both of them really accelerated the removing of loans from institutions, and then the derivatives on top of those and all of the other instruments, simply have nothing to stand on, and so the whole system did collapse.

Mr. Kupiec, is that a fair assessment of, just if you are trying to explain it in 2 minutes to the people of New Mexico, of what happened?

Mr. KUPIEC. The housing policies of the U.S. Government had a lot to do with the—

Mr. PEARCE. Originating here?

Mr. KUPIEC. Yes, sir.

Mr. PEARCE. And the idea that everybody should have a house even if they can't afford it. And, again, I think it is far more complex than what our friends would say.

Dr. Kohn, you had said that interest rates had helped in the recovery. Is there a downside? And I accept that premise, that they have helped somewhat. Is there a downside to the interest rate that has hurt the economy?

Mr. KOHN. It certainly has hurt savers.

Mr. PEARCE. Yes.

Mr. KOHN. And in some sense the whole—the idea of the low interest rate is to incent people to spend, to bring spending from the future to the present—

Mr. PEARCE. And present—

Mr. KOHN. —in order to increase employment, but people who are saving are hurt.

Mr. PEARCE. Yes. So if we could capture the tension, it has helped a little bit on one side in lowering the cost of getting into business, but on the other side, it has hurt consumption. Now we are at—

Mr. KOHN. I think it has helped consumption by lowering the cost of borrowing, but it certainly has—

Mr. PEARCE. I would say your cost to seniors has far outweighed that. In other words, we are a 70 percent retail economy, and every dollar you took away from seniors in interest that they did not get on the savings account—and seniors tell me, we lived our life right, we bought our houses, paid for them, have money in the bank, and now we get zero, 1 quarter of 1 percent. And so that removal from the purchasing stream has been a definite downside on the economy, and since we are 70 percent retail, I could argue, you could argue, but there is a tension in the system that it has been as punitive as helpful.

Now, Dr. Kupiec, you had had a fascinating view that the audit of the Fed was simply to see if the numbers have been worked correctly, that the GAO would take the calculator and we could oversee it. Now, if you use—and I would say that is a fairly good and easy way to explain it.

If you were to look at the Fed and their policy regarding interest rates, is it your opinion that they have implemented their policy correctly and fairly?

Mr. KUPIEC. I think the Fed was at a loss what to do after the financial crisis, and most of what they did was emergency reactions to the financial crisis. Once interest rates got close to zero, they didn't know what else to do, they bought securities and they kept buying securities, and any time Wall Street wanted to have a hiccup, they kept on buying securities.

I think they were reacting the only way they knew what to do, and I don't think they have come out of that yet. They are not sure how to get out of this problem to get back to normal. And the requirement to have them write down a strategy would allow you to have a better discussion of exactly how they are going to exit this very—

Mr. PEARCE. My time has run out. I appreciate that observation.

Dr. Kohn, again, not picking on you, but trying to get you to— the chance to speak on things that you and I might not approach the same. I don't know. So in business and in recovery, to me the biggest deal is not the interest rates. I had business equipment during President Clinton's—or President Carter's drive to 21 percent. It was devastating. I think, though, even though that was a very hard time, that the most powerful thing in the market is certainty, even more than the interest rate. And so the argument here of whether or not to audit, whether or not to take a deeper look, and you have heard Dr. Kupiec, I will give you the final 13 seconds, is certainty better or is the low interest rate better?

Mr. KOHN. It is better to be as certain as possible. And my concern is that more to force something that looks like it is going to be a rule, and be more certain than the world will allow would be counterproductive. The amount of volatility and uncertainty in the markets, I think, is pretty low these days. There are occasional jolts of volatility. I don't think there is any empirical evidence that markets are more uncertain about policy today than they have been in the past or they have been more uncertain over the last few years, except perhaps for fiscal policy.

Mr. PEARCE. Thank you. I appreciate that.

Mr. KOHN. I don't think uncertainty is high and I think we have to be worry—worry about trying to create more certainty than is warranted by the underlying structure of the economy.

Mr. PEARCE. Thank you, sir.

I yield back my time, Mr. Chairman.

Chairman HUIZENGA. Thank you. The gentleman's time has expired.

Seeing no other Members on the other side, we will continue on the Republican side with Mr. Messer of Indiana for 5 minutes.

Mr. MESSER. Thank you, Mr. Chairman. And thank you to the members of the panel.

Of course, it is Congress' responsibility to respond to the American people, the people who sent us here. I think when the American people look at the financial crisis and the response to the financial crisis, frankly, they are mad. And I think these are really complex issues, but I think the American people see it something like "Caveman Lawyer." I don't know how many of you have ever heard of "Caveman Lawyer," but he is a Saturday Night Live character and he was a Neanderthal who was frozen out of ice and now he is a plaintiff's attorney, and he gives closing arguments that go something like this: He says, I know nothing of your talking boxes and your flying machines, but I do know this, if a man slips and falls coming out of a Wal-Mart, he is entitled to $200,000 plus punitives.

And I think the American people look at all of what happened, and they understand they don't know all the complexities, but from their perspective, it looks something like this: There were a whole lot of rich people who were a part of creating this crisis; the crisis happened and all those rich people are still rich, and the average working family is struggling. Their savings haven't improved, their wages are flat, and they see a process that seems not very transparent, and they want to know who is accountable and responsible for it.

So as several of you have identified, obviously Congress has a responsibility to oversee the Fed, the Fed should be independent and it ought to make independent monetary policy decisions, particularly in the short term, but the Fed was created by Congress. Over time, we have shown an ability to change the way we provide regulatory oversight there, and the American people are demanding it.

So I was sort of fascinated. Let's start with Mr. Kupiec and Mr. Cochrane. You both mentioned that this is not your grandfather's Fed. Of course the regulatory structure of the Fed has changed, but its role in setting monetary policy has changed dramatically. I was fascinated, for example, by Mr. Kupiec's observation that the Fed is, in many ways, the world's reserve bank, and so there is potential pressure for the Fed to be asked to set policy that may not be in America's best near-term interest, because it is important for the global economy. So I would invite both of to maybe just highlight a way or a couple of ways in which, in English that the Caveman Lawyer could understand, the Federal Reserve's role is different than it has been in the past.

Mr. KUPIEC. The Federal Reserve's role has changed dramatically. In 1913, it was under a gold standard. It only accepted 90-day bills, commercial, paper, and agricultural bills, because they were self-liquidating. It wasn't supposed to have a big balance sheet. The gold standard constrained its creation of the money stock and Federal Reserve notes, and now the Federal Reserve has a huge balance sheet. It buys only long-dated securities. It has no short-term paper on its July 15th Open Market Committee statement. It has drastically changed.

In 1977, the Humphrey-Hawkins bill put in a dual mandate. Before that, the Fed had really no mandate, no mandated price stability or full employment.

Shortly after the 1977 bill, though, when Paul Volcker actually did take over, he was dragged before the Congress many, many times, and he argued—and when the Congress tried to beat up on him and say you have all these high interest rates, it is killing employment, you can go back and read the record, Paul Volcker said essentially, well, right now I have to get inflation under control before I can work towards the full employment requirement. So, in fact, it was discussed earlier.

Could Paul Volcker do what did he under this rule? Yes, he could. He would face the same scrutiny. Congress was not happy with him back then.

So I think the Federal Reserve has changed. Now it has a role where it lends to many foreign banks, it does currency swaps, it does all kinds of things that the Founders in 1913 never even thought of. And this is why something like a very thoughtful monetary commission, a centennial monetary commission to study all of these aspects and how the Fed actually fits into the world economy and how the Fed's mandate and tools and powers should evolve with its new place in the world, I think it is very timely.

Mr. MESSER. Thank you.

And Mr. Cochrane, in the limited 30 seconds left.

Mr. COCHRANE. The big difference is we have now financial markets that didn't exist back then. And when you think of the Fed, it is the world's biggest financial regulator and director of financial markets. We are criticizing here the Fed's interest rates for its effect on housing prices; not inflation, so much inflation, and unemployment.

The failure in 2008 was a failure of finance. Yes, people bought houses they shouldn't have bought, and yes, there was housing policy, but that killed the economy because it was funneled through ridiculously over-leveraged financial institutions that then went bust. The tech bust of the early 2000s didn't have any such effect, because it was just held in stocks. So these are the big issues for the Fed going forward. That was the big failure. Think of the Fed as the great financial regulator going forward as you do your good work.

Mr. MESSER. Thank you.

Chairman HUIZENGA. The gentleman's time has expired.

And seeing no other Members on the other side, we will proceed to Mrs. Love of Utah for 5 minutes.

Mrs. LOVE. Thank you, Mr. Chairman.

I would like to actually focus on the structure of the Federal Reserve System and the FOMC Board, and whether an argument can be made that reform of this structure is necessary to modernize the Fed for the 21st Century.

So just for a little bit of background, obviously not for your benefit, but for the benefit of the hardworking Americans who are listening, the Congress set up a decentralized system of 12 regional reserve banks with a system of seven members of the Board of Governors. The FOMC, in turn, is comprised of seven Washington-based Governors, the president of the New York Fed, and four of the presidents of the remaining 11 reserve banks on a rotating basis.

So with all of that and thinking about where that representation is, given that 8 of the 12 regional reserve banks are either on or the east side of the Mississippi, and six are within 600 miles of Washington, the question I would like to ask is, given the structure of the Federal Reserve System coupled with the FOMC structure, are the interests of the economic priorities of Americans in western States like Utah underrepresented in the monetary policy meetings?

And that is a question for everyone. We can start with you, Mr. Kupiec.

Mr. KUPIEC. I think it is timely that the structure of the system, people think about the structure of the system. It was the way it is because in 1913, politically, that is what it took to get the Federal Reserve Act passed. And some of the banks vote twice as often as the other banks. And it is even more complicated than your comments about the FOMC. Some of the banks vote twice as often as other reserve banks.

Mrs. LOVE. Right.

Mr. KUPIEC. So I think all this needs to be looked at. I think it is going to be politically very charged. Federal Reserve banks are politically very connected. Removing one from, pick your city, would be difficult.

Mrs. LOVE. Okay. I understand, politically charged, everybody wants to keep their power, but it is pretty much about whether—and this is something that should be concerning for both sides of the aisle, seeing how we are represented from all over the United States.

Do you have any thoughts about that?

Mr. KOHN. I think that there could be a rethinking of the geography of the Federal Reserve System and the reserve banks. And if there were a commission created, I would put that as part of its remit, given, as you say, things have changed so much.

I think there are two things to keep in mind, however. One is that every reserve bank participates equally in the discussions. And there have been many times in which if you didn't have a list in front of you of who were the voters and who weren't the voters, you wouldn't have been able to determine from the discussion which presidents had the vote and which didn't. All of the presidents have an equal say in the discussion. It is only at the very end when the roll is called that the presidents vote, so it is not a black-and-white situation.

The second point, I think, is that in this era of the Internet, et cetera, you can get information about anything from anywhere, and having—

Mrs. LOVE. But you are talking about people who actually represent—what I am trying to do is trying to diversify the thoughts. You are talking about people who are from and live in a certain geographical area. Utah has a growing banking presence, and I think, again, all over the United States, we have big, growing banking presences, and it is my opinion that those decisions shouldn't be made in groups that are just from one area, or heavily populated in one area.

What do you think can be done, Dr. Taylor, if you can add a little bit to this, to rebalance the FOMC to ensure that all Americans are equally represented in monetary policy discussions?

Mr. TAYLOR. Actually, I think the proposal in the legislation goes in that direction, because it equalizes the votes across the presidents. Of course, that means the New York Fed president is voting less and participating less. I think the votes do matter. But I think that is fine. I think there is—probably underlying this is a concern, well, maybe the New York Fed is just too high in this hierarchy, and this kind of equalizes that so it makes—

Mrs. LOVE. So you are actually saying that Congress does have something to offer when it comes to representing the people of the United States, and that it is actually good that we get involved in some of these discussions and find out ways that we can actually get the decision-making back into the hands of people all over the United States?

Mr. TAYLOR. [no verbal response.]

Mrs. LOVE. Thank you. I yield.

Chairman HUIZENGA. The gentlelady's time has expired.

And with that, we have reached the end of our period of time with our witnesses. And I would like to say thank you for your time and effort. This is, I think, very helpful as we are having this discussion.

Without objection, we do have a couple of things. I would like to submit the following statements for the record. We did get a statement from Representative Kevin Brady, who is the author of one of the pieces of legislation, and a letter from the Property Casualty Insurers Association of America. So without objection, those will be submitted.

I would also like to submit for the record a slightly different perspective on the charts. We will have dueling charts as to whether or not the Taylor Rule would bring us into negative interest rates. The chart that I am going to submit is produced by the St. Louis Fed and shows that actually doesn't happen based on the assumptions within the legislation as it is written. So without objection, that chart will also be included.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And with that, this hearing is adjourned.

[Whereupon, at 11:59 a.m., the hearing was adjourned.]

A P P E N D I X

July 22, 2015

Rep. Peter T. King Statement

Subcommittee on Monetary Policy and Trade hearing entitled "Examining Federal Reserve Reform Proposals" Wednesday, July 22, 2015

I appreciate the Chairman's continued efforts to improve the Federal Reserve System and I supported the Federal Reserve Accountability and Transparency Act when passed this Committee last year. However, I am opposed to a new provision in this draft that changes the composition of the Federal Open Market Committee (FOMC) and removes the New York Fed's permanent seat. This is a terribly misguided proposal and I would not support the final bill if it contains Section 4 of the discussion draft.

First, the New York Fed has domestic responsibilities that no other district bank has, including carrying out the country's monetary policy on behalf of the FOMC and the entire Federal Reserve System. Only the New York Fed engages in the buying and selling of U.S. government securities in the secondary market, which is the primary means of conducting monetary policy. Unlike the other district banks, the New York Fed interacts with the U.S. financial markets on a daily basis and therefore has a unique understanding of how the market reacts to changes in U.S. monetary policy.

Second, the New York Fed also conducts all foreign exchange trading for the Treasury and Federal Reserve System. It maintains all relations with foreign central banks and international organizations, providing them with financial services and holds foreign gold reserves. This engagement provides an important perspective on our foreign counterparts' activity and the impact of decisions made by the FOMC.

The New York Fed holds more than half of the Federal Reserve System's assets, holding more than four times the amount of the 2nd largest district bank. The press has reported that there is little support for changing the structure of the FOMC, with Presidents of the District Banks of San Francisco, Atlanta, Chicago and Cleveland all publically saying that they support the current structure of the FOMC and the permanent seat for New York.

Passing Section 4 of this draft ensures that significant expertise and institutional knowledge would be lost in the FOMC's decision making process, which has consequences that would be felt across the country. But for the people I represent – the role of the New York Fed, its proximity to the markets and sophisticated understanding of how they work, are critical to ensuring that New York City remains the preeminent financial center of the world. I would certainly not support any legislation that moves this idea forward, but I hope common sense will prevail and that the Chairman removes this provision from his bill.

U.S. Rep. Kevin Brady

Statement on

The Centennial Monetary Commission Act of 2015 (H.R.2912)

Before the Monetary Policy and Trade Subcommittee
Committee on Financial Services

July 22, 2015

A century ago, a series of financial panics highlighted weaknesses in the nation's monetary system. These panics led Congress to establish the National Monetary Commission. Based on the Commission's recommendations, Congress created the Federal Reserve System to provide a seasonally elastic currency in the context of a gold standard, and to function as the lender-of-last-resort to illiquid, but solvent commercial banks during a crisis.

As the crises preceding the Fed's creation illuminated the need for monetary reform, we too have much yet to learn from the financial crisis of 2008 and apply the lessons to monetary policy to ensure that America will have the strongest economy, job creation, and income growth in the 21st Century.

The global economy is vastly different than it was a century ago. Both the classical gold standard and Bretton Woods gold exchange standard are gone; currencies are fiat; exchange rates float; and the U.S. dollar serves as the world's reserve currency.

Moreover, the global economy is also vastly different than it was 40 years ago when Congress directed the Fed to use monetary policy to achieve both maximum employment and stable prices. By focusing on price stability as the prerequisite for strong economic growth and job creation, the Fed under the leadership of Chairs Paul Volcker and Alan Greenspan not only brought an end to the Great Inflation of the 1970s, but also established the foundation for the Great Moderation of the 1980s and 1990s that encompassed two of the longest and strongest economic expansions in our history.

However, new questions arose from the financial crisis of 2008 and the subsequent, unprecedentedly weak recovery that the 1977 paradigm cannot answer. Can monetary policy inflate asset prices rather than the prices of goods and services and therefore escape measurement by the Consumer Price Index (CPI) or the Personal Consumption Expenditure (PCE) Index? Did the Fed's monetary policy during the last decade help to inflate an unsustainable housing bubble? Should the Fed try to identify future asset price bubbles and do more to quell them before they become too large by tightening monetary policy? In this new environment, what do maximum employment and price stability mean?

Over the last century, Congress has expanded the Fed's role as a financial services regulator—most recently with Dodd-Frank's foray into macro-prudential supervision and regulation of "systematically significant" banks and non-bank financial institutions—but Congress has not authorized a truly comprehensive, independent review of the Fed's implementation of monetary policy.

It is past-time for a thorough, objective, and independent review of the Fed and its conduct of monetary policy. Such was the case with the National Monetary Commission a century ago; and so too would be the case with a Centennial Monetary Commission today.

In America's history, commissions have often served as an effective tool to help policymakers arrive at a consensus for important reforms on sensitive matters. *The Centennial Monetary Commission Act of 2015* (H.R.2912) follows in this tradition of commissions, including the original National Monetary Commission, from which emerged the Federal Reserve System, and the 9/11 Commission, which led to important intelligence reforms.

The Centennial Monetary Commission would review both the Fed's history in terms of economic growth, job creation, and financial stability, as well as the credible alternatives to our existing monetary policy; and it would make recommendations to Congress based upon its review.

My legislation would establish a 14-member Centennial Monetary Commission (CMC), consisting of 12 voting members with appointments divided evenly between the House and Senate; and one non-voting member appointed by the Secretary of the Treasury, and one non-voting member who is the President of a district Federal Reserve Bank, to be appointed by the Federal Reserve Chair.

The Commission would thoroughly examine how the Fed's monetary policy has affected our nation's output, employment, prices, and financial stability over the last century, and evaluate all of the major options for a monetary policy framework going forward.

These options would range from total discretion by the Federal Open Market Committee (FOMC) to one of several rule-based system that would guide the FOMC. Among the monetary policy rule options that the Commission would examine are: inflation targeting; nominal gross domestic product (n-GDP) targeting; the Taylor Rule; and a gold standard. In public hearings, advocates for each monetary policy framework would be able to present evidence and argue for their preference.

The Centennial Monetary Commission would examine both the Fed's expanded role as a macro-prudential regulator and the expanded scope of the Fed's lender-of-last-resort activities during the last financial crisis, with an aim to understand how these new activities may affect the Fed's ability to conduct monetary policy going forward.

The Commission would submit a report detailing its findings and making recommendations to Congress. It would recommend: (1) a legislative mandate for conducting monetary policy; (2) the Fed's operational regime for implementing its mandate; (3) what securities the Fed can use in its open market operations; and (4) ways for the Fed to increase its transparency in conducting monetary policy.

The question of monetary policy review and reform should be non-partisan. Republicans and Democrats alike should want to pursue the best monetary policy to help foster economic growth and job creation. Conservatives want growth to help balance the budget, reduce the size of the federal debt as a percentage of GDP, and ensure that America can keeps its promises to seniors. Progressives want growth to help fund a further expansion of the government. Regardless of the end, the necessary means are the same—are strong economy. The Centennial Monetary Commission would provide the forum to determine the best monetary policy to ensure that we have the strongest economy with strong job creation. This is a key element to ensuring that we enjoy another American century.

Testimony before the Subcommittee on Monetary Policy and Trade of the Committee on Financial Services of the U.S. House of Representatives

John H. Cochrane
Hoover Institution, Stanford University
July 22 2015

Chairman Huizenga, Ranking Member Moore, and members of the subcommittee: I thank you for the opportunity to testify on this important piece of legislation.

I am John Cochrane. I am a Senior Fellow of the Hoover Institution, a nonpartisan research institute at Stanford University. I represent my own views only.

It is wise for Congress and the Federal Reserve to rethink the fundamental structures under which the Fed operates. I think that the Fed wants guidance, and a settled relationship with Congress, as much as you want clarity. I view this legislation as an important first step in that process.

Principles

Two great principles underlie this effort: Independence and rules.

The Federal Reserve enjoys great independence. This independence is almost universally viewed as a good thing.

However, in our democracy, independence must be paired with clearly limited powers. And to the extent the Fed is granted or assumes larger powers, it must lose some of its independence.

For example, the Federal Reserve does not and cannot print money and hand it out, or drop money by helicopters in Milton Friedman's famous story. This kind of "stimulus" would be very powerful. In the depths of the recession, Federal Reserve officials surely would have wanted to do it. Many economists advocated "helicopter drops." But the power to write checks to voters in our democracy resides with the Treasury department and Congress. And for obvious reasons. Just who gets the checks and how much are deeply political decisions, and only an Administration and Congress which regularly face the wrath of voters can make them.

We also believe in rules, laws, and rule of law. We believe that independent agencies and their officials should, as much as possible, implement laws and rules, or at least traditions and precedents. They should not issue decrees at their discretion. And the more an agency follows rules, the more limited its powers, the more independent it can be.

Your task, and the Fed's, is to rethink the limits on Federal Reserve powers, to develop rules, to preserve its independence. And where such limits and rules are not possible, to limit that independence and oversee its decisions in the name of citizens, voters, and taxpayers.

Policies

Conventional monetary policy consists of setting short term interest rates, in response to, and with an eye to stabilizing, inflation and unemployment. Conventional monetary policy was limited to buying and selling short-term Treasuries to affect short-term rates, but will likely consist in the future of simply offering banks higher or lower interest rates on reserves and in loans from the Fed. You have heard much about rules in this context, and I think the bill before you does a good job of encouraging a fruitful framework for discussion between yourselves and the Federal Reserve.

But that is the tip of the iceberg. In the wake of the financial crisis and deep recession, the Federal Reserve has been given (by the Dodd-Frank act) and has taken on a wide range of new powers and responsibilities. Even more is being hotly discussed, under the label of "macro-prudential" policy. The Fed's perceived mandates — the central outcomes it should try to control — and its tools — what levers it can pull — have each expanded.

As natural with anything new, this has been a period of great experimentation and thus discretion. But as these experiments merge into regular policy, it is time to bring them in to the usual framework.

My main point today, is to encourage you to look beyond conventional monetary policy, and to consider what rules, mandates, limits, and oversight the Fed will follow in these newly expanded roles, or which of these mandates and tools you wish the Fed to stop pursuing and using.

Interest rate policy now goes beyond inflation and unemployment. The Fed is accused of stoking a housing "bubble" with too low rates in the early 2000s. Now, the big discussion concerns whether the Fed should raise rates to offset a perceived "reach for yield," high home prices, stock prices and bond prices.

Well, should the Fed be reacting to, or manipulating mortgage rates, exchange rates, and stock, bond, and housing prices? Is it even appropriate for Fed officials to offer opinions on whether stocks are too high or too low?

I think not. There is really no solid economic understanding of any link between the level of short term rates and these other assets. The Fed is as likely to do harm than good, to induce instability in prices from intense speculation about its actions. And manipulating asset prices is an intensely political decision, as the Chinese central bank is finding out, requiring a loss of independence. But I have come to pose the question, not to offer my answers

Perhaps the most important implication of a rule, say linking interest rates to inflation and unemployment, or a mandate, instructing the Fed to stabilize inflation and unemployment, is the long list of things that by implication the Fed should, at least in normal times, *not* respond, *not* try to control, and for which you, the Congress, will not hold the Fed responsible. This may be a useful interpretation for you to emphasize.

The Fed's arsenal of tools now goes far beyond setting overnight rates between banks.

In the recession, the Fed tried to manipulate long-term Treasury rates and mortgage-backed security rates, directly by buying lots of those securities. In the crisis, the Fed also bought commercial paper, to raise those prices. Some central banks buy stocks.

Should the Fed try to manipulate asset prices directly, by buying and selling assets? If so, under what conditions; i.e. with what rules, or with what supervision and loss of independence? Again, I think not. But again, you have to think about it.

Here, the Fed-Treasury separation I praised over fiscal policy has broken a bit. The Treasury's Office of Debt Management traditionally manages the maturity of government debt in private hands, and thus the Treasury's exposure to interest rate risk. In the period that the Fed was buying up long-term debt, trying to reduce the amount in public hands, the Treasury was issuing lots of long-term debt, trying to increase it. They each undid the other's actions. Clearly, some accord is needed over who has responsibility for the maturity structure of the debt.[1]

The Fed is also the prime financial regulator. Since 2008, under the Dodd Frank act, and of its own volition, the Fed's regulatory role has expanded enormously. "Systemic stability" is an implicit third or fourth mandate. And the Fed is contemplating "macro-prudential policy," combining regulatory and expanded monetary policy tools to achieve both macroeconomic and financial goals. What rules and limits will this effort respect?

The Fed now exercises "enhanced supervision" of the "systemically designated" banks, exchanges, and insurance companies. Dozens of Fed staff live full time at these institutions, reviewing details of their operation. This exercise follows few rules, great discretion, and little accountability to you.

The "stress tests" are one example, which this bill begins to address. The Fed made up this procedure in the financial crisis, and it seemed to give confidence in the banks. But this temporary expedient has now become a permanent ritual. The stress tests follow no preset rules. The Fed deliberately tries to surprise the banks with novel tests each time. The thinking goes, I suppose, that if the banks knew the rules ahead of time, as they know their capital requirements or leverage ratios, they would jigger the books to pass the tests. But the result is a highly discretionary decision by Fed officials, on which billions of dollars and the competitive fortunes of banks rest. That is not a good basis for a permanent policy. I am glad that your bill brings some structure to this enterprise. But not totally glad, as the bill then institutionalizes stress tests and perhaps we should get rid of them instead.

An earlier example is starker. In the robosigning affair, the Federal Reserve joined with the US and states Attorneys General, and used its "safety and soundness" regulatory power to force banks to write down mortgage principal — not on the robosigned homeowners, but on completely unrelated homeowners — and to give money to "nonprofit housing counseling organizations." Writing down prinicipal — a transfer from bank shareholders to homeowners — is a fiscal and macroeconomic policy. Whatever its wisdom, it clearly detracts from bank safety and soundness. Though the example is small, I think it provides a clear case of compromised independence, and the use of regulatory powers to effect macroeconomic and fiscal policy

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[1]See Robin Greenwood, Samuel G. Hanson, Joshua S. Rudolph, and Lawrence Summers, "Government Debt Management at the Zero Lower Bound." Hutchins Center Working Paper, No. 5, September 2014, for details.

interventions[2]. You may or may not approve; you may or may not want the Fed to do such things with complete independence.

The heart of "macroprudential" proposals is the idea that central banks will vary capital ratios, lending standards (loan to value ratios) or other regulatory tools over time, along with interest rates, to stop emerging "bubbles," or to "stimulate" as need be. The Fed may even try to constrain bank lending in regions of the country, such as those with high housing prices, or to encourage others. Well, your bubble is my boom, and home buyers and builders will be calling you when the Fed restricts credit. These are political decisions. Do they rise to the writing-checks-to voters standard that an independent agency should not perform? You must decide the limits on this sort of power you wish to impose, and what rules you wish the Fed to follow.

This bill's requirements for cost benefit analysis are an important step in managing the regulatory explosion. The costs of regulatory compliance and the costs to competitiveness, innovation, and entry into financial services strike me as quite large. But one should not expect the filling out of more mountains of paper to mechanically stop the juggernaut, or more importantly to produce better and clearer regulation, especially when so much rule-making is mandated by Congress itself under the Dodd-Frank act.

The Fed is hotly debating other important changes. Will it maintain a large balance sheet and pay interest on reserves, or revert to the previous rationing of reserves? I prefer the former, for its great financial stability benefits. Will it allow people and non-banks to access interest-paying reserves, the most safe, liquid, and run-free asset imaginable? People will like that, banks will not like being undercut.

The Task

These are all examples of the momentous changes underway in our central bank, as in other central banks around the world. Just how the Fed should approach these issues, which tools and goals it can follow while remaining independent, what rules and legal constraints it can follow in its decisions, what the structures of oversight will be, and how independent it can remain are important issues for you, and the Federal Reserve, to decide.

My main message for you today is to use this bill as a first step in that much broader discussion, and to think beyond conventional monetary policy.

Final thoughts on monetary policy

In part, monetary policy is not, now, obviously broken. The outcomes we desire from monetary policy are, one must admit, about as good as one could hope. Inflation is basically non-existent. Short term rates are as low as we have seen in two generations. The labor market is functioning normally. Economic growth has been steady and bond markets quiet.

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[2] My source here is the Federal Reserve website, and I applaud the Fed's transparency in making these materials public.
http://www.federalreserve.gov/newsevents/press/enforcement/20120209a.htm
http://www.federalreserve.gov/newsevents/press/enforcement/20120213a.htm
http://www.federalreserve.gov/newsevents/press/enforcement/enf20120213a1.pdf

Yes, growth is far too slow, not enough people participate or participate fully in the labor force, wages are stagnant, and we face many other economic problems. But these are problems that the monetary policy really can't do much about. Congress asked for price stability ([which somehow the Fed interpreted to mean 2% inflation), maximum employment, and low interest rates, and we got them. The Fed has limited powers and limited responsibilities, and the purpose of this bill is to define such limits. Each of us has our own opinions whether the Fed should raise rates or not, but there is no strong professional consensus that the Fed is, right now, doing something dramatically wrong.

This benign outcome is, one must also admit, a bit of a puzzle. When interest rates hit zero, traditional Keynesians predicted a deflationary vortex. When the Fed bought nearly 3 trillion dollars of bonds, creating new money in exchange, traditional monetarists predicted hyperinflation. The Fed's own forecasts — along with everyone else's — have been wrong 7 years in a row. With interest rates stuck at zero, conventional monetary policy has obviously nothing to do with this outcome. We all have our theories - I'll be glad to fill you in on mine, if you'd like — but there is no professional consensus on how this remarkably benign state of affairs was reached.

Monetary policy is also much less powerful than most commentators — and most Fed officials — will admit. Money is like oil in the car. Not enough, and the car will stop. But once you have enough oil, adding more does not help the car to go faster. Controlling the car's speed by slightly starving it of oil is not wise. And more oil will not substitute for clogged fuel injectors.

Like most commentators, I feel that the Fed's discretionary monetary policy is damaging, as evidenced by financial markets that hang on every sneeze by Fed officials. A more predictable policy may add some stability to financial markets, and enable people who are investing in businesses to do so with more confidence. At least they could be paying more attention to fundamentals and less to parsing Fed officials' pronouncements. But the combined facts of a benign outcome, at least so far, limited scientific understanding of just how monetary policy works, and limited power of conventional monetary policy, lead me to recommend that this not be the main focus of your efforts.

The massive expansion of Fed responsibilities, the many new tools it is now using, and in particular the temptation to use direct regulatory control to achieve nearly unlimited economic objectives, strike me as the most important topics for a discussion about rules, independence, mandates, and accountability.

Hearing on "Examining Federal Reserve Reform Proposals"
Testimony of Donald Kohn[1]
House Committee on Financial Services
Monetary Policy and Trade Subcommittee
July 22, 2015

Mr. Chairman and Members of the subcommittee:

You have before you a long list of proposed legislative changes applying to the Federal Reserve, some of which would make important changes in the character of the institution, its policy processes, and its authorities. At the same time you are also considering the formation of a commission to examine whether indeed the Federal Reserve should be altered to make it a more effective institution. The basic premise of both of these strands is that something has been seriously amiss with the way the Federal Reserve has carried out the responsibilities Congress has given it.

I do not agree with that premise. 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. The Federal Reserve, working in part under the guidance of the Congress in Dodd Frank, has greatly toughened and improved its regulation and supervision of the institutions for which it is responsible, and the financial system is safer than it has been for many years.

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 a 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.

Congress has established goals for monetary policy, given the experts at the Federal Reserve insulation from short-term political pressures to set their policy instruments to meet those goals, and then held the Federal Reserve accountable for the outcomes. The Senate, in its role in appointments to the Federal Reserve Board, has a critical say in making sure the right experts are in place to carry out this

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[1] Senior Fellow, Economic Studies Program, Brookings Institution, and external member of the Financial Policy Committee at the Bank of England. The views are my own and should not be attributed to the staff, officers or trustees of the Brookings Institution or the Bank of England.

responsibility. You have recognized that this model of independent but accountable central banking has proven to work better in the public interest than one in which political pressures can be brought more forcefully to bear on the central bank instrument settings. I urge you to keep the current balance in place.

Let me address just a few of the proposals.

Policy Rules and GAO audits. Being as systematic, predictable, and transparent as possible about what the Federal Reserve is doing increases the effectiveness of monetary policy because it helps private market participants accurately anticipate Federal Reserve actions. It also enhances your ability to assess the policy strategies of the FOMC. The Federal Reserve should explain why it has chosen the instrument settings it has, how those settings are expected to foster achievement of their responsibilities, and on what basis they might evolve in the future. The FOMC has taken a number of steps to increase the predictability and transparency of its actions, especially over the past 10 years.

But "as possible" is the key phrase in that first sentence of the previous paragraph. The Federal Reserve, the Congress, and private market participants must recognize the limits of our knowledge of economic relationships, including the relationship between changes in policy instrument settings and progress toward the Federal Reserve's legislated objectives. 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.

The result is that the Federal Reserve must use all available information that might shed light on evolving economic relationships and the effects of policy, and use it in a flexible manner. Statistical economic models relating future inflation, economic activity, and labor market slack to incoming information about the economy and to financial variables have proven especially unreliable over the past eight years of financial market disruption; history has been a poor guide to the future in these unprecedented circumstances. Models and policy rules can be useful inputs for policy, but they are only inputs and cannot be relied on as hard guides to policy settings to achieve the Federal Reserve's objectives.

To be sure, policy has taken unexpected steps over the past seven years, but this was in response to unexpected developments. Moreover, the recovery from the financial crisis was disappointingly slow. But it would have been even slower had the FOMC not undertaken unconventional and sometimes unexpected policy actions. The pricing of actual and expected volatility in financial markets has not suggested an unusual amount of uncertainty about the path of interest rates or the Federal Reserve's portfolio holdings going forward.

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. If it is adhered to it will produce inferior results; if it is not, as I would hope and expect, it would be misleading.

If the Federal Reserve were to frequently alter and deviate from policy rules you would require it to publish under the proposal, as I expect it would, then the GAO would be frequently second guessing FOMC decisions. Indeed, under another section of the proposed legislation the exemption for monetary policy from GAO audit would be repealed.

Congress was wise to differentiate monetary policy from other functions of the Federal Reserve in 1978 when it authorized GAO audits of those other functions. It recognized that the GAO audits could become an avenue for bringing political pressure on the FOMC's decisions on the setting of its policy instruments. Around the same time, Congress clarified the objectives for policy and it established reports and hearings to hold the Federal Reserve accountable for achieving those objectives. It also recognized that over time and across countries, experience suggested that when monetary policy is subject to short-term political pressures, outcomes are inferior; in particular inflation tends to be higher and more variable.

In that context, the extra pressure of GAO audits of policy decisions moves the needle in the wrong direction. At some point, and I hope before too long, the labor market will be strong enough and the prospects for inflation to rise will be good enough that the Federal Reserve will begin to tighten policy to avoid overshooting its two percent inflation target. That will not be popular with some political observers. The Congress made a good decision in 1978 and I urge you to stick with it and find other ways to inform your oversight of monetary policy.

Changes to emergency lending powers for nonbanks. Supplying liquidity to financial institutions by lending against possibly illiquid collateral is a key function of central banks. Indeed, having an institution to do this in the U.S. was a major impetus behind Congress establishing the Federal Reserve in 1913. When confidence in financial institutions erodes and uncertainty about whether they can repay the funds they borrowed increases, they experience runs—those supplying funds to banks and other intermediaries stop. Without a backup source of funding, lenders are forced to stop making loans and to sell assets in the market at any price. The resulting drying up of credit and fire sale of assets severely harms the ability of households and businesses to borrow and spend and can result in deep recessions with high unemployment. Borrowing from a central bank under such circumstances helps lenders continue to meet the credit needs of households and businesses; it is an essential way for the central bank to cushion Main Street from the loss of confidence in the financial sector.

For most of the twentieth century the Federal Reserve could perform that function adequately by lending to commercial banks and other depositories. But in the past few decades, intermediation in the U.S. has shifted from banks to securities and securitization markets. In 2008, the Federal Reserve found that lending to nonbanks—to investment banks, money market funds, buyers of securitizations—was required to stem the panic and limit the damage to Main Street. Some of what we did, however necessary, was uncomfortable—in particular lending to support individual troubled institutions, like AIG, or to support of the acquisition of Bear Stearns. The Federal Reserve supported giving the FDIC an alternative method of dealing with troubled financial institutions and limiting the use of the discount window for nonbanks to facilities that would be widely available to institutions caught up in the panic.

Congress made those changes on lending to nonbanks in Dodd Frank and added a few more 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 have already done might limit the effectiveness of the Federal Reserve's lender of last resort function for a twenty-first century financial market—make panics even harder to stop and raise the risk that households and businesses would lose access to credit. The restrictions you have already placed on 13-3 lending, the resolution authority you have given to the FDIC, and the higher capital requirements on systemically important institutions are in the process of eliminating the moral hazard of any remaining perceived benefit from nonbank access to lender of last resort.

We need to keep in mind that difficult judgments are required in such a situation—especially about solvency and collateral valuations. The nature of a financial crisis is that the line between liquidity problems and solvency problems is not clear—institutions that might be insolvent if their assets were sold at fire sale prices might be comfortably solvent when the panic subsides; collateral whose value has dropped sharply in the panic will recover as the panic subsides. 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 Monetary Commission. As I said at the beginning of my testimony, no institution is perfect; all need to learn lessons and adapt. The Federal Reserve has been adapting its monetary policy strategy and communications. The Federal Reserve, the other regulators, and the Congress have addressed many of the deficiencies in regulation and supervision that allowed the circumstances that led to the crisis to build.

As I also noted, I do not believe that major changes have been identified that would make the Federal Reserve a significantly more effective public policy institution. But I recognize that the geographical structure of the System was set in 1914; some of the relationships among its constituent parts, including the make-up of the monetary policy committee, in the 1930s; and its monetary policy goals and reporting in the late 1970s. I cannot rule out that a group of thoughtful policy experts might be able to suggest some further improvements to goals, structure, and decision-making processes.

But 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.

The Congress has given the Federal Reserve Board, with its members appointed by the president and approved by the senate, a clear majority on the FOMC, even when there might be a vacancy on the Board. And it has given the Board authority over discount window lending by the reserve banks as well as their operations. I believe that public support for the Federal Reserve in our democratic society requires that the authority of the Board not be eroded.

American Enterprise Institute for Public Policy Research

Statement for the United States House of Representatives, Committee on Financial Services, Subcommittee on Monetary Policy and Trade

Examining Federal Reserve Reform Proposals

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July 22, 2015

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Examining Federal Reserve Reform Proposals

Chairman Huizenga, Ranking Member Moore, and distinguished members of the Subcommittee, thank you for holding today's hearing and for inviting me to testify.

I am a resident scholar at the American Enterprise Institute, but this testimony represents my personal views. My research is focused on banking, regulation, and financial stability. I have included my full resume as an appendix to my testimony, but to summarize my background, I have extensive experience working on banking and financial market policies at the Federal Reserve Board (FRB), the International Monetary Fund, the Federal Deposit Insurance Corporation (FDIC), and the Bank for International Settlements. It is an honor for me to be able to testify before the subcommittee today.

I will begin my testimony with remarks regarding proposed legislation H.R. 2912.

1. **The Centennial Monetary Commission Act of 2015**

Since its founding in 1913, the Federal Reserve has evolved into an institution with responsibilities and powers that would scarcely be recognized by drafters of the original authorizing legislation. The Federal Reserve is among the most powerful government institutions both in terms of its ability to set monetary policy, to engage in emergency lending relationships and as a regulator of individual financial institutions, clearing and payments systems, and financial markets. Since the Centennial Monetary Commission Act is focused on the Fed's role in carrying out monetary policy, for the moment I will ignore the Fed's evolution as a financial regulator and focus on recalling some of the more important changes that reshaped the Federal Reserve's monetary policy operations since 1913:

- In 1913, the Federal Reserve was restricted to discounting self-liquidating 90-day commercial and agricultural paper; it now owns nearly $2.5 trillion in long-term US government notes and bonds and $1.75 trillion of 30-year mortgage backed securities.[1]
- In 1913, the Fed's operations were constrained by a fixed exchange rate system and the international gold standard. Today, the Federal Reserve owns no gold, and the Fed's standard operating procedures use the exchange rate as an indirect monetary policy tool.

[1] Federal Reserve Bank of New York, System Open Market Account Holdings, July 15, 2015. http://www.newyorkfed.org/markets/soma/sysopen_accholdings.html

- In the early 1920s, the Fed welcomed deflation as the best means of rebalancing a war-inflated economy.[2] Today the Fed argues that a constant 2 percent inflation rate is the best target for achieving "price stability" because the economic risks of deflation are so grave.[3]
- In the early 1930s, in response to the onset of the Great Depression, the Congress gave the Fed new powers. The Banking Act of 1933 (the so-called Glass-Steagall Act) created the Federal Reserve Federal Open Market Committee, which allowed US Treasury securities to serve as collateral for Federal Reserve Notes,[4] and gave the Fed the power to set the maximum rates banks could pay on deposit accounts. It also accorded the Fed the authority to set margin requirements for loans made to finance securities, and empowered it to set the reserve requirements on Federal Reserve member banks.[5]
- Controlled by the US Treasury for the first 40 years of its history, the Fed gained its "independence" from the US Treasury and the executive branch in March 1951 following a contentious public debate with the US Treasury and President Truman. The so-called "Federal Reserve Treasury Accord" relaxed President Truman's demand that the Fed continue to monetize public debt by pegging long-term interest rates.[6] In more recent times, the Fed has tried to argue that its "independence" extends to its dealing with the US Congress.
- After experiencing high inflation and unemployment in the mid-1970s, in 1977, Congress gave the Fed a new dual mandate to maintain stable prices and maximum employment.
- In 1980, Congress revised the Federal Reserve's powers and phased out its power to cap interest rates on all accounts except demand deposits.

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[2] Federal Reserve policy circa 1919-1920 is documented in detail in, James Grant (2014), "The Forgotten Depression: 1921." Simon & Schuster.
[3] See, Board of Governors of the Federal Reserve, http://www.federalreserve.gov/faqs/economy_14400.htm
[4] Prior to 1932, Federal Reserve Notes had to be backed by gold (40 percent) and eligible commercial and agricultural paper (60 percent). See Wheelock (1992) "Monetary Policy in the Great Depression: What the Fed Did, and Why," Federal Reserve Bank of St Louis, https://research.stlouisfed.org/publications/review/92/03/Depression_Mar_Apr1992.pdf
[5] Today, the Fed set's the *minimum* rates banks' earn on their reserve deposits at the Fed and the Fed hasn't used margin requirements or reserve requirements as a policy tool for decades.
[6] Following the Accord, Truman replaced the noncompliant Fed Chairman McCabe with William McChesney Martin, the Treasury official who negotiated the Accord on Truman's behalf. After his appointment, Chairman Martin adopted the Fed goals of price and macroeconomic stability, opposing Truman's view that the Fed should maintain peg interest rate to maintain the price stability of government war bonds. See Hetzel and Leach (2001), "The Treasury-Fed Accord: A New Narrative," Federal Reserve Bank of Richmond Economic Quarterly, p. 33-55.

- In 2010, Congress again revised the Federal Reserve's powers. It modified the Fed's power to lend in "unusual and exigent circumstances"; it gave the Fed new macroprudential powers to be used to prevent the formation of assets bubbles and future financial crisis; and it removed interest cap on demand deposit accounts.

While the short-run monetary policy decisions of the Federal Reserve should not be dictated by the US Congress, the Federal Reserve is not independent of the Congress. The Fed exists because of legislation enacted by Congress, and Congress has a duty to exercise oversight over the Federal Reserve, including modernizing the Federal Reserve Act when appropriate. Congressional duties include setting the Federal Reserve's long-run goals that guide the Fed when it formulates short-run monetary policy strategy and determining what other financial sector duties are best discharged by the Federal Reserve System.

From my abbreviated history of Congressional changes to Federal Reserve Act, it is clear that, from time to time, the US Congress finds it necessary to re-examine the Fed's mandate, powers, and responsibilities, and to revise legislation appropriately. Given the dramatic changes in Federal Reserve monetary policy operations following the financial crisis, and the apparent waning power of traditional monetary policy instruments, it is apropos to reassess the operating mandate, powers, structure, and strategy of the Federal Reserve System. My only reservation is that the Centennial Monetary Commission Act of 2015 may not allow sufficient time and is insufficiently aggressive in the scope of Federal Reserve powers and operations it proposes to review.

The 1907 National Monetary Commission met for a number of years (1909-1912) and produced a number of influential reports. The Centennial Monetary Commission is scheduled to finalize a report by December 2016, and to cease all operations by the following June. Given that the Commission has not yet been authorized, let alone organized, this life span seems unnecessarily abbreviated if the goal is to complete a substantive report.

The scope of the Centennial Monetary Commission should be expanded to require the commission to consider the merits of modernizing the structure of the Federal Reserve System and to consider whether Federal Reserve duties should be concentrated on monetary policy, monetary policy and financial stability, or in fact whether its current mandate of monetary policy, financial stability and extensive responsibilities for individual financial institution supervision best serves the public interest. It is not clear that the public interest is served by a Federal Reserve that is heavily involved in supervision of banks and bank holding companies, especially when the Fed is vocal about using its Dodd-Frank expanded macroprudential powers to keep financial activity from "leaking out" of the banking sector into the "shadow banks."[7]

As part of its charter, the Centennial Monetary Commission should be asked to formulate an updated mandate for Federal Reserve for monetary policy. In 1977, the Congress amended the Federal Reserve Act to set the Fed's mandate:

> "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."

Price stability and maximum employment are appropriate Federal Reserve mandates in the abstract, but the wide latitude given to the Federal Reserve to interpret these goals has given rise to controversy.[8] The movement to require the Fed to assess their policies relative to a benchmark, such as the Taylor rule, is an example of this controversy. Perhaps the desire to push the Fed in the direction of using an explicit monetary policy rule could be attenuated if the Fed's monetary policy mandate was stated with greater specificity in its authorizing legislation.

Moreover, in decades since the 1977 Humphrey-Hawkins legislation, the Federal Reserve has gained importance internationally and currently fills a role that is very close to one that can be described as the "central banker for the world." Given this evolving role, the Fed will, at some point, undoubtedly face pressures to undertake monetary policy operations that will immediately benefit foreign nations or large institutions but may not obviously be in the

[7] See, for example, Daniel Tarullo, "Advancing Macroprudential Policy Objectives," January 30, 2015. http://www.federalreserve.gov/newsevents/speech/tarullo20150130a.htm

[8] Indeed the controversy began with the Humphrey-Hawkins bill itself. Senator Humphrey wanted to give the executive branch a greater role in formulating monetary policy. He proposed that the president should submit his policy recommendations to the Federal Reserve, and the Fed should have 15 days to explain why monetary policy cannot follow the president's proposed strategy. See,Aron Steelman (2011), Federal Reserve Bank of Richmond Economic Brief 11-12.

long-term best interest of promoting domestic price stability and maximum employment. The Centennial Monetary Commission is an appropriate body to examine these important issues and update the Federal Reserve mandate to reflect modern developments.

2. The Federal Reserve Reform Act of 2015

The "Federal Reserve Reform Act," as proposed by Chairman Huizenga, includes 13 separate sections. Some of these sections involve relatively small amendments to Federal Reserve responsibilities that should, in my view, generate little controversy. These noncontroversial sections include: (§3) the mandatory FOMC public comment "blackout period"; (§6) increasing the frequency of Congressional briefings by the Federal Reserve Chairman and/or Vice Chairman; (§9) allowing each Federal Reserve Board member at least two Board staff to assist the governor in administering his/her duties and disclosing the salaries of highly compensated Federal Reserve system staff; and (§12) moving the responsibility for setting interest rates paid on reserve balances from the Federal Reserve Board to the FOMC. I will concentrate my testimony on the sections that are likely to generate more debate.

2.1 Requirement for Policy Rules of the Federal Open Market Committee (Sec 2)

Based on §2 of the draft legislation, my understanding is that the law requires three things:

(1) It requires the Federal Reserve to specify a so-called "directive policy rule"—the monetary policy rule that the FOMC uses to determine the open market operations directives it gives to the New York Federal Reserve bank open market desk. This directive instructs the desk to carry out specific policy operations to achieve a policy target. The directive policy rule should be in the form of an equation. The variables in the equation should be well-defined including an explanation of how and by whom these variables are calculated. The equation must explicitly include the values of any coefficients that generate the policy directive. The Fed must also explain how the outputs from the policy directive rule are translated into specific monetary policy operations using the instruments available to conduct market interventions. The Fed may deviate from its directive policy rule if market conditions have changed from those that prevailed when the FOMC formulated its directive policy rule.

(2) It requires the Federal Reserve to calculate the policy directive that would be generated by a so-called "reference policy rule" which is defined as a specific simple formulation of a

Taylor rule for setting nominal interest rates under an inflation targeting regime. The Fed must explain how the operations directive generated by its directive policy rules differs from the operations directive that would be generated by the reference policy rule, and explain to Congress why this difference is appropriate given prevailing economic conditions.

(3) After each FOMC, the GAO will verify whether the Fed's open market operations directive is consistent with the Fed's directive policy rule. If the directive policy rule does not appear consistent with the policy directive given to the New York market desk, the GAO must confer with the Fed and report any apparent changes in the Fed's directive policy rule to appropriate Congressional committees. If the GAO detects a change in the directive policy rule, the Fed must appropriately update the directive policy rule and appear before the appropriate Congressional committees to explain the changes. If the Fed does not make these changes in a timely manner (within 7 days) and explain them to Congress, the Congress may instruct the GAO to audit the Fed's processes for determining its directive policy rule.

Discussion: This legislation would require the FOMC to provide Congress and the public with a transparent statement of the methodology which the FOMC is using to set short-run monetary policy targets. It does not restrict the Fed regarding the form or function of the directive policy rule it may adopt, and it may change its directive policy rule at will, should conditions change or the best practice "science" of monetary policy evolve. In this respect, the new requirement leaves the Fed's independence to set short-term monetary policy completely intact. However, this change would significantly improve the transparency of the process the Fed uses to determine short-run monetary policy objectives.

The requirement that the FOMC also produce a reference monetary policy directive using the Taylor rule does not appear to be an overly burdensome requirement. No doubt the Fed already produces such a calculation internally as the FOMC policy makers would certainly want to know what interventions are recommended by standard monetary policy targeting rules. The formal reporting of alternative baseline monetary policy prescriptions to appropriate Congressional committees would only enhance the quality of the discussions when the Federal Reserve Chairman appears before Congress in the newly-mandated quarterly briefing schedule. Any clear difference in policy recommendations between the reference policy rule and the directive policy rule will undoubtedly generate lively discussion and the Fed will be required to defend its policy actions to the Congress. This seems fully appropriate and an intended goal of the legislation.

The third feature of this proposal seems sensible enough. The GAO is merely called upon to validate that the Fed's instructions to the New Yok operations desk are consistent with the recommendations of the FOMC's directive policy rule. If the GAO finds an inconsistency that the Fed cannot explain to the GAO's satisfaction, the Fed may have to revise its directive policy rule and explain the new rule to appropriate Congressional committees.

There is nothing in this proposal that restricts the Fed from choosing any directive policy rule that meets the FOMC's needs and objectives. Fed independence is only compromised to the extent the FOMC's monetary policy decision processes would be made more transparent and therefore more easily monitored by Congress and the public.

2.2 FOMC Membership (Sec 4)

This legislation would change the FOMC voting rights of Federal Reserve district bank presidents. Instead of 4 bank presidents voting on an unequal rotating basis, and the president of the New York Federal Reserve bank always voting, 6 bank presidents would have FOMC votes each year. On odd-number years, the presidents of the reserve banks in Boston, Philadelphia, Richmond, Chicago, Minneapolis and Dallas would vote. On even-numbered years, the president of the reserve banks in New York, Cleveland, Atlanta, St. Louis, Kansas City, and San Francisco would vote.

<u>Discussion</u>: This change is appropriate. The uneven voting representation of some Federal Reserve districts may have, in the past, been justified by differences in regional contributions to aggregate financial and economic activity, but such differences no longer persist. Some reserve banks that currently enjoy favored voting rights are far less important today than they were in the 1930s.

Another potential problem with the proposal as it is currently written is that it does not designate any change in the method for selecting the vice chairman of the FOMC. Currently, the president of the New York reserve bank is designated as the FOMC vice chairman. Congress might consider specifying a process to select the FOMC vice chairman position should Congress desire that this position rotate among the voting district bank presidents. Alternatively, Congress could continue the current practice and keep the New York reserve bank president as the permanent FOMC vice-chairman even though this vice chairman would only vote on even-numbered years.

2.3 Stress Test Transparency and Disclosure of Supervisory Correspondence (Sec 5)

This legislation would require the Federal Reserve Board to issue formal regulations that govern its mandated Dodd-Frank Stress testing process, including the CCAR stress test, and disclose the models that the Board uses to estimate losses on "certain assets." It would also require the Board of Governors to disclose the number of supervisory letters it has sent to bank holding companies and specify how many of these were "Matters Requiring Attention" and "Matters Requiring Immediate Attention."

Discussion: This new requirement is badly needed. The Federal Reserve Board's stress test process is highly opaque. The legal language should be amended to require that the Federal Reserve Board disclose the models it uses to estimate stress test losses on *all* material asset classes examined in the stress test.

The Federal Reserve Board is likely to argue that a requirement to disclose the stress test models that the Board uses to generate loss estimates on individual asset classes will allow bank holding companies to "game' their stress test results. I do not think that this is a legitimate concern, provided the Board's models are accurate. However, if the Board's models significantly understate the losses on some asset classes, and the banks identify the Fed's mistake, then banks may find it advantageous to overweight asset classes for which the Board's models understate risk.

This feature of the stress testing process is not a reason to avoid the disclosure recommended in the legislation—rather it is a reason to avoid the use of stress testing results for the supervision of individual financial institutions. Stress test models are inherently inaccurate, and some of the Federal Reserve Board's models will undoubtedly be wrong. Still, there is no valid reason for keeping the Fed's stress testing process opaque and allowing the Board to penalize banks for "inaccurate" loss estimates or "inadequate" qualitative and governance processes when the Federal Reserve Board will not reveal its own internal loss models.

2.4 Cost-Benefit Analysis and Review of New Regulations (Sec 8)

This legislation has three parts. Internal Federal Reserve Board regulations, regulations related to monetary policy, or any emergency actions are expressly exempt from this proposed regulation.

(1) Before issuing any new regulations, the Federal Reserve Board must clearly assess: (i) the source, nature and significance of the problem that the proposed regulation will address, and assesses whether any new regulation is warranted; (ii) the costs and benefits of the proposed regulation; (iii) and the costs and benefits of exempting some groups from the regulation; and (iv) identify other possible remedies and compare these remedies to the proposed regulations.

(2) The Federal Reserve Board must choose the approach that maximizes net benefits including meeting the objective without imposing undue burden on credit availability or economic growth or unintendedly disadvantaging any particular business or entity or disadvantaging job creation, global competitiveness or other enumerated factors.

(3) Once a regulation is in place, the Federal Reserve Board must conduct a study to evaluate whether the regulation is meeting its intended objective without creating negative, unintended, and unanticipated consequences. The evaluation must be completed no later than 2 years after the rule is adopted unless the Board publishes a notice of extension in the Federal Register explaining why an extension is necessary. After making and publishing the assessment, the Board must publish a notice for public comment stating that it intends to amend, rescind, or take no additional action regarding the regulation.

Discussion: The Federal Reserve has been exempt from regulations that require it to perform cost/benefit analysis to justify the issuance and formulation of new regulations. This proposal fills a loophole in exiting regulatory law. If this proposal advances, Congress should consider applying a similar regulation on the FDIC as that agency is also currently exempt from a requirement to perform cost-benefit analysis as part of its regulatory process.

As the proposal is currently drafted, the Federal Reserve Board must undertake a cost-benefit analysis to justify a new regulation, but it is unclear if, when and how this cost-benefit analysis is to be made public. Only two public disclosures are mentioned in the proposal: (i) "the Board shall explain in its final rule the nature of the comments it received and provide a response to those comments in its final rule....”; and, (ii) disclose in the Board's postmortem assessment two years after the regulations is implemented.

The proposed legislation lacks any mechanism for assessing the adequacy of the Federal Reserve Board's cost-benefit analysis. Must the analysis be vetted in an appropriate Congressional committee? Must it be made public on the Board's website? Can its adequacy and conclusions be challenged in a court of law and, if so, what parties have standing to challenge the assessment? Perhaps the legal modalities associated with mandatory cost-benefit analysis are already established elsewhere in legislation or in case law. If so, I am not aware of the rules that apply. Still, language could be added to clarify these issues.

Another consideration is the length of time involved in the implementation of many banking regulations. Many banking regulations are phased in over an extended period of time to minimize market impact. The proposal's requirement for a Federal Reserve Board assessment two years after the implementation of a regulation might be modified to account for the length implementation periods commonly adopted by regulators.

2.5 Notification of Intent to Engage in International Standard Setting Bodies (Sec 10)

This legislation would require:

(1) The Federal Reserve Board, the FDIC and the US Treasury to notify the public and appropriate Congressional committees 30 days before any staff of these agencies enter into negotiations or consultations with international standard setting bodies like the Financial Stability Board, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors or other similar organizations. These agencies must solicit public and Congressional comment on the topic matter, goals and scope of the negotiations or consultation. After the consultation, the agencies must issue a public report describing the topics that were discussed at the meeting and any policy changes or new rulemaking that may result from these meetings.

(2) The Federal Reserve Board, the FDIC and the US Treasury to notify the public and appropriate Congressional committees 90 days before any staff from these agencies enters into an agreement with international standard setting bodies like the Financial

Stability Board, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors or other similar organizations. These agencies must solicit public and Congressional comments on the proposed agreement, its goals and its anticipated economic effects, and any new domestic rules making or policy changes that will be required as a result of the agreement.

Discussion: This proposal should be implemented at once. The language should be tightened to ensure that the public and appropriate Congressional committees are made aware of all international standard setting body meetings that have material implications. This may require further specifying the meaning of "negotiation" and "consultation" to ensure that the agencies satisfy Congressional intent.

It is curious that the proposal excludes any mention of the Securities and Exchange Commission, the Commodity Futures Trading Commission and their participation in in international standard setting negotiations and agreements [e.g., International Organization of Securities Commissions]. Unless this omission is intentional, perhaps the proposal should be expanded to include these agencies as well.

2.6 Federal Reserve Special Lending Powers (Sec 11)

This segment of the proposed law would modify the Federal Reserve's §13(3) special lending powers. Instead of being able to lend to lend to nonbank financial firms under "unusual and exigent circumstances," if the proposal becomes law, these unusual and exigent circumstances would also have to "pose a threat to the financial stability of the United States." The loan would also have to be approved by at least 9 presidents of district Federal Reserve banks. Furthermore, the provision precludes the Fed from taking equity securities as loan collateral, and requires the Fed to establish rules that restrict its lending process by specifying: acceptable collateral, collateral valuation methods, a process for setting collateral haircuts, and a penalty lending rate. The proposal also adds a requirement that the assisted firm meet the Dodd-Frank definition of a financial firm. The Fed is also prohibited from lending, "until such agency has certified in writing to the Board that the person is not insolvent."

Discussion: This proposal goes a long way toward removing concerns that the §13(3) provisions in the Dodd-Frank Act are sufficiently permissive that the Fed could once again legally lend to stop an individual distressed and potentially insolvent financial firm from failing.

Two issues merit further clarification. One issue is that the proposal is directed at the Federal Reserve Board, but it is the Federal Reserve district banks that actually do the lending. Perhaps the language should be amended to make clear that any lending under "unusual and exigent circumstances" by the Federal Reserve System district banks must meet these requirements.

A second issue requiring additional clarification is the phrase, "until such agency has certified in writing to the Board that the person is not insolvent." The proposal, as far as I can tell, does not specify which specific agencies are empowered to make the required solvency determination. Further clarification is needed.

2.7 GAO audits (Sec 13)

This legislation repeals exiting prohibitions for GAO audits of the Fed's monetary policy functions. Specifically, Section 13 removes the following language from exiting law [31 U.S. Code §714]:

> *[GAO] Audits of the Board and Federal reserve banks may not include—*
>
> *(1) transactions for or with a foreign central bank, government of a foreign country, or nonprivate international financing organization;*
> *(2) deliberations, decisions, or actions on monetary policy matters, including discount window operations, reserves of member banks, securities credit, interest on deposits, and open market operations;*
> *(3) transactions made under the direction of the Federal Open Market Committee; or*
> *(4) a part of a discussion or communication among or between members of the Board and officers and employees of the Federal Reserve System related to clauses (1)–(3) of this subsection.*

Discussion: This provision is necessary to allow the GAO to validate that the FOMC's policy directive is consistent with the FOMC's directive policy rule reported to Congress. This provision is merely enabling legislation for Section 2 of the proposed legislation.

Federal Reserve Reform Proposals

John B. Taylor[1]

Testimony before the Subcommittee on Monetary Policy and Trade
Committee on Financial Services
U.S. House of Representatives

July 22, 2015

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 volume[3] 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 speech[4] 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."

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[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 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 testified[8] 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.

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[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

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Nathaniel F. Wienecke
Senior Vice President, Federal Government Relations

July 22, 2015

The Honorable Bill Huizenga
Chairman
Subcommittee on Monetary Policy and Trade
Committee on Financial Services
U.S. House of Representatives
1217 Longworth House Office Building
Washington, DC 20515

Dear Chairman Huizenga:

I write to commend you for introducing legislation that includes appropriate requirements for notice and comment and public disclosure for international insurance negotiations. The state insurance departments are currently the primary functional regulators for insurance companies and work to protect consumers both domestically and in international insurance negotiations.

However, there are now multiple U.S. representatives at several important international standard setting bodies, such as the International Association of Insurance Supervisors and Financial Stability Board. Unfortunately, these international entities lack essential transparency and individual member accountability. Positions taken by the U.S. representatives on insurance issues are not always united or reflective of the goals of the insurance regulators to protect insurance policyholders.

Section 10 of the draft Huizenga bill provides for greater transparency and opportunity for public and Congressional input into international insurance negotiations. Section 8 further provides for cost-benefit analysis for certain new Federal regulations. PCI supports greater transparency and public comment in international insurance negotiations as well as appropriate cost-benefit analysis before major new international insurance standards are adopted or imposed on the domestic U.S. marketplace. PCI looks forward to working with Chairman Huizenga and other members on these important issues.

PCI's members include more than two-thirds of the insurers that partner with the NFIP through the "write-your-own" (WYO) program to sell, service, and administer this federal program. PCI is composed of almost 1,000 member companies, representing the broadest cross-section of insurers of any national trade association. PCI members write over $183 billion in annual premium, 35 percent of the nation's property casualty insurance. Member companies write 42 percent of the U.S. automobile insurance market, 27 percent of the homeowners market, 32 percent of the commercial property and liability market, and 34 percent of the private workers compensation market.

Sincerely,

Nathaniel F. Wienecke

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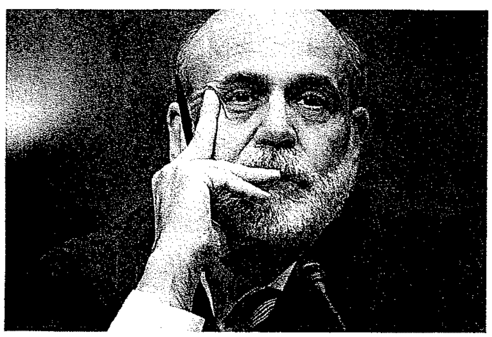
THE WALL STREET JOURNAL.

http://www.wsj.com/articles/taylor-on-bernanke-monetary-rules-work-better-than-constrained-discretion-1430607377

OPINION | COMMENTARY

Taylor on Bernanke: Monetary Rules Work Better Than 'Constrained Discretion'

We have had a serious financial crisis, a very deep recession, a not-so-great recovery, and now a virtually strategy-free international monetary system. This is not a good record.



Former Federal Reserve Chairman Ben Bernanke *PHOTO: REUTERS/KEVIN LAMARQUE*

By **JOHN B. TAYLOR**
May 2, 2015 6:56 p.m. ET

In a recent blog post Ben Bernanke criticized the use of rules-based monetary policy in which the central bank endeavors to set the instruments of policy in a predictable rule-like manner.

The post attracted a lot of attention, but this is not the first time Ben has criticized rules-based monetary policy. Soon after he joined the Federal Reserve Board he gave his "constrained discretion" speech in 2003 criticizing such policies, focusing his criticism on Milton Friedman's well-known rule for the money supply. His recent criticism of rules-based policy focuses on the Taylor rule. It is similar to his criticism in 2010 in a major speech before the American Economic Association, which I responded to here in The Wall Street Journal, and it is an elaboration of his talk at a recent IMF conference where I also gave a talk and we had a little debate. In his 2003 speech Ben advocated "constrained discretion" as an alternative to rules-based policy, and judging from his talk at the IMF conference, "constrained discretion" is still his view of how policy has been conducted in recent years and how it should be conducted in the future.

Ben's blog post starts off with a nice summary of the Taylor rule from my 1993 paper. The summary is accurate except for the suggestion that I put the rule forth simply as a description of past policy when in fact the rule emerged from years of research on optimal monetary policy. In his IMF talk he also quotes at length from that 1993 paper to demonstrate, perhaps in a gotcha sense, that I did not think policy could be conducted mechanically.

I never thought that policy should be mechanical and still don't. Some people say that I want to chain the Fed to an algebraic formula, but that is not what I have written or said. Having a rules-based policy for your instruments does not mean you mechanically follow a formula. It means you have an explicit strategy for setting the instruments. The same is true for my recommendation regarding legislation.

In his blog post Ben then goes on to critique "Taylor's critique of Fed Policy." But he defensively focuses entirely on the period when he was on the Fed Board. In fact, as I described in my recent IMF talk, my critique of the Fed goes back to the terrible economy of the 1970s when, much as in recent years, the Fed was "highly discretionary and interventionist" with "lofty goals but no consistent strategy." And that critique became praise when Fed policy changed and became "more focused, more systematic, more rules-based" in the 1980s, 1990s and until recently with excellent results. Many economists have written about this change including Rich Clarida, Jordi Gali and Mark Gertler.

Ben's defense of the 2003-2005 period (the "too low for too long" period when he was on the Board) is based on the idea that those rates could be justified by changing the Taylor rule coefficients or changing the inputs in a way that suggested that interest rates were not too low, as shown in his Figure 2. This is the same argument used in his 2010 criticism when he considered other changes in the Taylor rule, and my response to that earlier criticism applies directly to his recent criticism.

It should be obvious to anyone that if you double the size of a coefficient in a policy rule (as Ben does) that you can radically alter the results. If Ben is suggesting that the Fed was secretly using such a rule in those years (unbeknownst to people outside the Fed at the time), then that is a good reason to make public such rules as legislation in Congress would require.

Despite Ben's own reinterpretation of the Taylor rule history, many people besides me have shown that rates were too low then, including Marek Jarocinski and Frank Smets, George Kahn, and work at the OECD by Rudiger Ahrend. Figure 1 from Bill Poole when he was on the FOMC shows this clearly as does this old graph from the Economist. In his talk at the IMF conference where Ben and I presented, Hyun Shin presented a convincing graph showing the too low rates globally. In fact, the changes in policy are so large that they can be illustrated without a specific rule.

Here is a simple plot of the inflation rate with different settings of the federal funds rate. It shows that with the inflation rate around 2%, the federal funds rate was only 1% in 2003, compared with 5.5% in 1997 when the inflation rate was also about 2%.

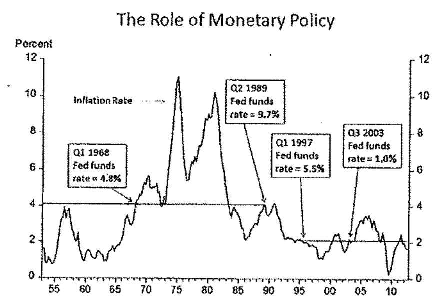


PHOTO: JOHN TAYLOR

Ben lists a number of other criticisms of policy rules. He says that there are differences of opinion about the size of the output gap. That's certainly true, but it is no more of a problem for rules-based policy than for discretion—constrained or otherwise—where some estimates of the economy's potential or gap are nearly universally needed.

He says that it is problematic to assume that the equilibrium real federal funds rate is 2%. Well that has been what the FOMC members have been saying for years, and according to the dots they are still pretty close to that in their long run estimate of the nominal funds rate around 3.75% and an inflation target of 2 %. But if they want to change, that can easily be incorporated into a rules based framework as Chair Janet Yellen has recently mentioned in San Francisco.

Ben says that a policy rule for the interest rate gives no guidance when the reading on the rule is negative. I completely disagree with that. The zero bound is not a new problem. Policy rule design research took that into account decades ago. The default was to move to a stable money growth regime not to massive asset purchases. And back in the year 2000 David Reifschneider and John Williams proposed another rules-based approach to deal with the problem.

Ben says there is no agreement on how much to react to changes in output or inflation. That is not quite right as there is much agreement about the so called "Taylor principle" that the reaction of the interest rate to inflation should be greater than one. But, again, disagreement about sizes of coefficients or elasticities in economics is a problem for the discretionary approaches too, and without a rules-based framework it is nearly impossible to understand the ramifications of that disagreement.

In its essence, Ben's critique is of rules-based strategies for the instruments of policy in general rather than of particular policy rules. He prefers "constrained discretion." As I see it, the broader evidence in the United States and in many other countries that Ben does not mention is that a rules-based policy has worked and that discretion—constrained or otherwise—has not.

We have had a serious financial crisis, a very deep recession, a not-so-great recovery, and now a virtually strategy-free international monetary system. I am sorry, but this is not a good record, even though, as I have emphasized many times, the Fed did an excellent job in its lender-of-last-resort role during the panic in the fall of 2008.

Mr. Taylor is a professor of economics at Stanford University and senior fellow at the Hoover Institution.