

Requirements for Policy Rules for the Fed

Testimony Before
The Committee on Financial Services
United States House of Representatives

February 11, 2014
John B. Taylor *

Chairman Hensarling, Ranking Member Waters, and other members of the Committee on Financial Services, thank you for the opportunity to testify at this hearing on HR 5018, “The Federal Reserve Accountability and Transparency Act.” In this written testimony I will focus on the first main section of the Act entitled “Requirements for Policy Rules for the Federal Open Market Committee.”

The Need for Legislation

Research by many people over many years has shown that predictable rules-based monetary policy is essential for good economic performance. It leads to price stability. It leads to overall economic stability, and it creates conditions for strong steady employment growth and productivity growth. My own research going back more than four decades supports this view, and such a view has become embedded in macroeconomic theory thanks to the work of Robert Lucas, Finn Kydland, Edward Prescott and others.¹

And the research continues today: At a conference last spring at Stanford’s Hoover Institution George Shultz, Allan Meltzer, Marvin Goodfriend, Michael Bordo, Richard Clarida, David Papell, John Cochrane, Lee Ohanian, William Poole, Jeffrey Lacker, and Charles Plosser all spoke about the advantages of a rules-based monetary policy.² The view that monetary policy rules work is also supported by historical and statistical evidence. During periods when policy is

* Mary and Robert Raymond Professor of Economics at Stanford University and George P. Shultz Senior Fellow in Economics at Stanford University’s Hoover Institution.

¹ John B. Taylor, “Estimation and Control of a Macroeconomic Model with Rational Expectations,” *Econometrica*, 47 (5), September 1979, 1267-1286; Robert E. Lucas, “Econometric Policy Evaluation: A Critique,” in *The Phillips Curve and Labor Markets*, Karl Brunner and Allan Meltzer (Eds.) Amsterdam: North-Holland. 1976; Finn Kydland and Edward C. Prescott, “Rules Rather Than Discretion: The Inconsistency of Optimal Plans,” *Journal of Political Economy*, 1977, 85. 473-493. For a summary of this and succeeding research see John B. Taylor and John C. Williams “Simple and Robust Rules for Monetary Policy,” in Benjamin Friedman and Michael Woodford (Eds.), *Handbook of Monetary Economics*, Elsevier, 2011, 829-859.

² Frameworks for Central Banking in the Next Century, May 28-30, 2014, <http://www.hoover.org/events/frameworks-central-banking-next-century>

more rules-based as in much of the 1980s, 1990s and until recently, the economy has performed well. During periods such as the 1970s and the past decade when policy has been more interventionist and discretionary, economic performance has been poor. That the shifts in policy preceded the shifts in economic performance is compelling evidence that the changes in policy have been a cause of the changes in economic performance.

Central bank independence alone has not prevented the departures from steady rules-based policy. Robust indices of de jure central bank independence show virtually no change in the past 50 years.³ In other words within a given legal framework, policy makers have been able to engage in varying degrees of adherence to rules-based policy. Indeed these very swings from rules to discretion—especially the swing from rules to excessive intervention in the past decade—demonstrate the need for legislation requiring the Fed to adopt rules for setting its policy instruments.⁴

For these reasons, the new requirements for policy rules for the Fed put forth in Section 2 of the “Federal Reserve Accountability and Transparency Act of 2014,” are most welcome.

On the “Requirements for Policy Rules for the Federal Open Market Committee”

The legislation is well-designed and well-balanced. It takes account of the research described above and the practical experiences with monetary policy during the history of the Federal Reserve and other central banks.

It incorporates different views about the instruments and transmission process of monetary policy while maintaining throughout the important principle that central bank decisions should be based on strategy or a rule with limits placed on discretion and excessive intervention in a transparent and accountable way.

It builds on lessons learned from experiences with earlier legislative initiatives requiring reporting on the monetary policy instruments, including the requirement to report ranges for the monetary and credit aggregates which were removed from the Federal Reserve Act by the American Homeownership and Economic Opportunity Act of 2000.

It allows the Fed to serve as lender of last resort or take appropriate actions in the event of a crisis.

It provides appropriate and effective Congressional oversight without micromanaging the operations of the Fed or reducing its operational independence to choose a monetary strategy.

³ Christopher Crowe and Ellen E. Meade, “The Evolution of Central Bank Governance around the World,” *Journal of Economic Perspectives*, Vol. 21, No. 4, 69–90, 2007

⁴ John B. Taylor, “Legislating a Rule for Monetary Policy,” *The Cato Journal*, 31 (3), Fall, 407-415, 2011.

It thereby meets the goal enunciated by Milton Friedman many years ago of “legislating rules for the conduct of monetary policy that will have the effect of enabling the public to exercise control over monetary policy through its political authorities, while at the same time it will prevent monetary policy from being subject to the day-by-day whim of political authorities.”⁵

In particular, the Act would require that the Fed “submit to the appropriate congressional committees a Directive Policy Rule... which shall describe the strategy or rule of the Federal Open Market Committee for the systematic quantitative adjustment of the Policy Instrument Target to respond to a change in the Intermediate Policy Inputs.” Thus, the rule would describe how the Fed’s policy instrument, such as the federal funds rate, would change in a systematic way in response to changes in the intermediate policy inputs, such as inflation or real GDP. The rule would also have to be consistent with the setting of the actual federal funds rate at the time of the submission.

It is important to note that under the proposed legislation the Fed, not the Congress, would choose its Directive Policy Rule and how to describe it. But if the Fed deviated from its rule, then the Chair of the Fed would have to “testify before the appropriate congressional committees as to why the [rule] is not in compliance.”

The legislation also creates a transparent process for determining if the rule is in compliance: The Comptroller General of the United States would be responsible for determining whether or not the Directive Policy Rule was in compliance and report its finding to Congress.

The legislation provides flexibility. Of course, the policy rule itself does not require that any instrument of policy be fixed, but rather than it flexibly adjusts in a systematic and predictable way to economic developments. Moreover, the legislation allows for the Fed to change its rule or deviate from it, if the Fed policy makers decide that is necessary. “Nothing in this Act shall be construed to require that the plans with respect to the systematic quantitative adjustment of the Policy Instrument Target be implemented if the Federal Open Market Committee determines that such plans cannot or should not be achieved due to changing market conditions.” But “Upon determining that plans...cannot or should not be achieved, the Federal Open Market Committee shall submit an explanation for that determination and an updated version of the Directive Policy Rule.”

The legislation also requires that the Fed’s report to the congressional committees “include a statement as to whether the Directive Policy Rule substantially conforms to the Reference Policy Rule” along with an explanation or justification if it does not. “The term ‘Reference Policy Rule’ means a calculation of the nominal Federal funds rate as equal to the sum of the following: (A) The rate of inflation over the previous four quarters. (B) One-half of the percentage deviation of the real GDP from an estimate of potential GDP. (C) One-half of the

⁵ Friedman, Milton (1962), *Capitalism and Freedom*, University of Chicago Press, Chicago, p 53.

difference between the rate of inflation over the previous four quarters and two. (D) Two. This is the Taylor Rule.⁶

This requirement will not put any undue burden on the Fed and it usefully makes a connection between the Fed's analysis and that of many in the private sector. Describing the difference between a policy rule being investigated and this particular "reference rule" is a task undertaken routinely by researchers working on different policy rules, so it is a straightforward task for the Fed. In fact, many at the Fed already make such comparisons including Fed Chair Janet Yellen.⁷ Of course the legislation does not require the Fed to follow any particular rule, but only to describe how the Fed's rule might differ from this reference rule.

There is precedent for the type of Congressional oversight in the proposed legislation. Previous legislative language, which appeared in the Federal Reserve Act until it was removed in 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 requirements for reporting ranges for the monetary aggregates were removed from the law in 2000, nothing was put in its place. A legislative void was thus created concerning reporting requirements and accountability. In many ways the proposed legislation fills that void by replacing the reporting requirements for the policy instruments that were then removed from the Federal Reserve Act.

Conclusion

In sum HR 5018—including the section on policy rules I discussed here and the later sections on cost-benefit analysis and transparency—promises to improve greatly the operation of monetary policy in the United States and thereby lead to better economic performance, especially compared to much of the past decade.

Of course, some will likely object to the legislation, including some at the Fed. But based on writings, speeches, and publically released transcripts of meetings, we know that many at the Fed favor a more rules-based policy either now or in the future. Informed and constructive comments from the perspective of the Fed would undoubtedly improve the legislation, but if the proposed legislation were passed into law, I am sure the policymakers and the staffs in the Federal Reserve System could make it work to a good end.

⁶ John B. Taylor, "Discretion Versus Policy Rules in Practice," *Carnegie-Rochester Series on Public Policy*, North-Holland, 39, 1993, 195-214 and Center for Economic Policy Research Publication No. 327, Stanford University, November 1992

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